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INTERNATIONAL TRADE FINANCE

BY

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NEW YORK
HENRY HOLT AND COMPANY

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To
My Mother

PREFACE

International business since 1914 has passed through an evolution more rapid than had occurred in all its history before that year. The war and the post-war periods have been marked by depreciating exchanges and fluctuating price levels. These have influenced seriously the organization of international banking and business, and have changed vitally their methods of operation.

The subject of foreign exchange in the broad sense of the word may be viewed from a variety of angles, from each of which due consideration should be given to the profound economic changes which have occurred since 1914. The general principles of monetary science established a half century ago still remain unimpaired, but they must be re-examined and revised in the light of recent happenings. If foreign exchange be viewed as a phase of foreign trade, then sufficient weight must be given to the existence of the enormous present international indebtednesses; as, for example, Germany's obligation to the allied countries, or Europe's debt to the United States. If foreign exchange is studied as a phase of credit, attention should be directed to the effects on the system of international credit resulting from the most precipitous rise and fall in 1920 of prices in recent economic history. If foreign exchange is regarded from the standpoint of rates, then due thought must be given to the facts of dislocation and to the causes. A book on foreign exchange which confines its calculations to pre-war rates has much in common with the texts of medieval

scholasticism. The use of the old parities is ordinarily defended on the ground that they represent normal conditions and that present rates are merely temporary deviations. Close students of foreign exchange believe that most of the depreciated European exchanges will never attain their pre-war values and hence cannot be regarded as representing the normal. If the technique of trade financing be stressed, then due thought should be given to the legal and practical alterations which bankers have made in credit instruments and documents in order to protect themselves and their customers against a recurrence of the widespread cancellation of international contracts following the world crisis of 1920.

With due regard to the various viewpoints and also with full consideration of the limitations of each, what subjects then should be included in a study of foreign exchange, international banking, and trade finance? First, attention should be given to the balance of international payments between the United States and the rest of the world, thus indicating all the transactions which give rise to foreign exchange. It should then be shown how these transactions are effected through the mechanism of exchange in the form not of money but of credit. The international nature of credit should be explained in order to establish a sound theoretical foundation on which to build the treatment to follow.

Foreign exchange should be considered in the light of fluctuating market conditions as well as from the standpoint of the methods whereby parties engaged in international business seek to protect themselves against loss from fluctuating rates. The war has completely transformed the structure of overseas banking in Europe and has promoted the movement toward internationalizing the banking system of the United States. This evolu-

tion deserves careful consideration as well as the merits and demerits of both the branch and the correspondent systems for maintaining interbank relations abroad.

Foreign trade may be financed either by the business man or the banker, and so the credit policies of these parties require study. Attention must also be directed to the sources of foreign credit information because they differ in nature from those in gathering domestic credit data. Credit insurance as an effort to protect business against credit losses is an interesting experiment hitherto little understood. Because of the greater risks involved in granting foreign credit, extensions are largely based on collateral as evidenced by documents. The technique and the law covering these instruments have changed as a result of new methods and court decisions which should be understood by all parties interested in trade financing. The methods of trade financing, whether the exporter or importer or their respective banks assume the credit burden, have undergone numerous changes to meet the new needs. The methods of creating acceptances and the operation of the discount market in New York and London present phases which have hitherto been untouched. Lastly, attention must also be directed to the financing of trade to countries with depreciated currencies which give rise to practical problems, unknown before the war.

The general treatment of these subjects in this book is not confined to the United States. It is designed to include a comparative study of practice in the commercial nations of Europe particularly, as well as of South America and the Far East. The export of agricultural products, as well as of manufactured goods, is covered.

This book should be of some interest to the student of world economics, to the lawyer with legal problems in

international finance, to the business man whether agriculturalist, manufacturer, or middleman seeking foreign markets, and to the banker engaged in overseas finance. The book is addressed particularly to the inland banker, who operates no foreign department of his own but who seeks through his correspondents to give his customers an international financial service, and wishes to learn its technique.

The material for this book was gathered by the author in his work for the Federal Reserve Board and for the Department of Commerce, in Europe and in the United States; Chapter XV and parts of several other chapters have appeared in a bulletin of the Bureau of Foreign and Domestic Commerce. The entire subject matter has been organized through teaching it in undergraduate and graduate courses at Columbia University, and later at New York University. The material has thus been tested by classroom use and should serve as a text book, treating not only foreign exchange but also international bank organization and trade financing. It is supplemented with a selective bibliography of references available in the average library. The material for this book has been gathered through direct observation and from libraries. The author spent considerable time in the public and financial libraries in New York, London and on the Continent but he is particularly indebted for data from the libraries of the American Bankers Association, the National Bank of Commerce and the Guaranty Trust Company of New York, the Midland Bank of London, the Disconto Gesellschaft of Berlin and the Rotterdam Bank of Amsterdam.

For their patience and consideration in answering numerous questionnaires formulated in connection with his studies, the author wishes to express deep appreciation

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to his fellow members of the Foreign Exchange Club of New York City, and to the many bankers whose suggestions have been invaluable. He is particularly obligated to his colleague Professor James D. Magee and to Mr. Marcus Nadler of the Division of Analysis and Research of the Federal Reserve Board, who aided in writing Chapter XIV. Acknowledgment is also due to Mr. N. R. Browne, Credit Manager, International Western Electric Company, to Mr. Karl Frederick of the New York Bar, to Mr. J. Stemple of the National Bank of Commerce, to Mr. S. Stern, Vice President and Director, Seaboard National Bank, to Mr. J. Swingle, of the Asia Banking Corporation, and to Mr. Benjamin B. Tregoe, Jr., of the Credit Men's Association.

G. W. E.

NEW YORK CITY, 1924

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PART I

FOREIGN EXCHANGE AND
INTERNATIONAL BANKING

CHAPTER I

BALANCE OF INTERNATIONAL PAYMENTS

DEVELOPMENT OF MODERN BUSINESS IN WESTERN EUROPE

The fundamental activity of man, is to obtain a living or to engage in what is known as "business." He has certain economic wants which he seeks to satisfy by means of material commodities and personal services. The evolution of these wants and the consequent development in goods, that is, commodities and services, form a study as fascinating as the purely political struggles which usually fill the pages of the histories of human activities. A brief review of the economic history of Europe and the United States is needed as a background for a full understanding of modern business activities which give rise to international payments between nations.

The political and economic characteristics of present day life had their origin in Western Europe at the close of the Middle Ages. By this time most people found that they could best satisfy their wants for food, shelter and clothing by working together in agricultural communities known as "manors." Towns were developed by those persons

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who preferred to gain their living not by tilling the soil but by domestic manufacturing or by trading. Thus the manorial system and the craft and merchant guilds developed side by side. The economic wants of the people were thus satisfied largely within their own communities, and so both town and country life in the Middle Ages were forms of purely local economy. This stage of industrial organization disappeared about the end of the Sixteenth Century which marked the rise of the modern political state and the coming of national economy. Men no longer thought themselves part of a manor or a town but of a nation, and their economic interests widened correspondingly.

International economy did not make its appearance until about the middle of the Eighteenth Century. True, foreign trade can be retraced to the early Phoenicians, Carthaginians, Greeks and Romans, but after the collapse of the Roman Empire international commerce was almost non-existent, until the Crusades stirred all Europe and opened trade lines with the East. The discovery of America changed the entire course of this commerce. The cities of Genoa and Venice declined in importance as commercial centers, with the rise of Lisbon, Antwerp, Amsterdam and London. Thus for several centuries international commerce flourished in a few business centers but exerted relatively little influence on the economic structure of society until well into the

Eighteenth Century, when the Industrial Revolution began to transform completely the economic life of Western Europe. In England a series of mechanical inventions such as the steam engine, the spinning jenny and the power loom swept away household or domestic industry and established the modern factory system. Men no longer worked at turning out a complete product, but now toiled at only a single operation, and so industrial society was reorganized more fully than hitherto in accordance with the principles of the division of labor. The production of goods was increased to such an extent that they could no longer be consumed in the home market and had to be sold abroad. Although England was the first to enter the stage of international economy and hence of international marketing, this point of development was attained by most states of Western Europe before the close of the Nineteenth Century.

DEVELOPMENT OF BUSINESS IN THE UNITED STATES

Every country sooner or later passes through the three stages of local, national and international economy. This is true even of a new land which starts its economic existence as a colony, although this first stage differs somewhat in nature from the local economy of older countries as described above. A colony in its earliest period lacks sufficient labor and capital but abounds in natural resources;

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so it turns to the development of extractive industries and with products thus derived obtains in exchange its finished goods from abroad. Thus a country in a state of colonial economy from the start is highly dependent on foreign markets, and cannot very well buy without selling. This was the situation of the American Colonies even after they had won their political independence from the mother country, for they continued to export food-stuffs and raw materials and import finished goods until the time when it proved cheaper to obtain them at home. This change did not take place in the South until after the Civil War, but began in the Northeast about the opening of the Nineteenth Century when the restrictive measures imposed upon neutrals during the Napoleonic Wars by England and France impeded foreign commerce.

This step marked the end of our colonial economy and the beginning of national economy. The use of machinery was started in the Northeast where manufacture was first developed due to the supply of labor and the presence of water power. This section had no need to seek foreign markets for its surplus manufactures, since it was able to sell them to the Middlewest and the South. The former was engaged largely in food production, the latter in cotton culture, and so territorial division of labor was gradually developed. Unhampered by tariff barriers and aided by improvements in trans-

portation such as the invention of the steamboat, the digging of canals and the building of railroads, the internal commerce of the United States grew rapidly during the first half of the Nineteenth Century. To a considerable extent, the development of this internal commerce was dependent on foreign trade largely in wheat and cotton shipped through northeastern seaboard cities to foreign ports. This external commerce included only a small proportion of manufactured goods, for these found a well-nigh insatiable market among the western settlers who were step by step advancing the frontier across the Continent.

The United States did not enter the stage of international economy until the last quarter of the Nineteenth Century when the reconstruction period following the Civil War and the westward movement to the Pacific Coast finally came to a close. The settlement of the slave labor question and the passing of the frontier were interrelated factors which ended the era of extensive growth and began the period of intensive economic development. This was especially true of manufacture which soon turned out products far in excess of home needs and so the export of finished goods rapidly increased. Conversely agriculture, notwithstanding the widespread application of farm machinery, in time experienced the operation of the law of diminishing returns and only an ever dwindling surplus of food-

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stuffs was available for exportation after the requirements of home consumption were met.

THEORIES ON INTERNATIONAL TRADE. — THE MERCANTILISTS

Important economic changes generally lead to the formulation of theories and principles by thoughtful observers interested either in interpreting events or in controlling them through legislation. So when Europe and particularly Great Britain developed from local to national economy, this transition was accompanied by a consequent change in economic theory and also in legislative action. Economists and statesmen who accepted the principles of mercantilism, as the new nationalist school of thought was known, were concerned in the upbuilding of political states, whose economic strength was supposed to be measured by their stocks of gold and silver. At first a supply of such precious metals was sought by prohibiting their exportation from the country. The mercantilists in time saw the futility of trying to check the outflow of specie merely by legislation and later sought to accomplish their aim by economic policy. This was based on the theory that by having an excess of exports over imports, or what is known as a favorable balance of trade, a nation would receive payment for the difference in specie and so add to its wealth and power.

MERCANTILE AND CLASSICAL THEORIES COMPARED

Mercantile theories were quite universally held until the close of the Eighteenth Century when the change from national to international economy led to their re-examination by the so-called "English classical economists" who formulated a new set of theories which with certain modifications and re-statements are generally accepted up to the present day. The mercantilists and the classical economists differed in their theories on the economic relations among nations. The former steadfastly believed that one power could gain trade only at the expense of others; the latter contended that the growth of international commerce may be beneficial to all parties. Adam Smith was the first to point out that the economic interests of peoples were not necessarily hostile but harmonious, since foreign trade, he writes:

"carries out that surplus part of the produce of their land and labour for which there is no demand among them, and brings back in return for it something else for which there is a demand. It gives a value to their superfluities by exchanging them for something else which may satisfy a part of their wants and increase their enjoyments. By means of it the narrowness of the home market does not hinder the division of labour in any particular branch of art from being carried to the highest perfection. By opening a more extensive market for whatever part of the produce of their labour may exceed the home consumption it encourages them to improve and to augment its annual produce to the utmost and thereby to increase the real revenue and wealth of society." ¹

¹ *Wealth of Nations* (ed. Nicholson), p. 181.

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In other words foreign trade extends the principle of the territorial division of labor and enables countries to concentrate their efforts on those commodities for whose production they have relatively the best facilities. According to this doctrine of comparative costs, although two nations such as the United States and Great Britain could both manufacture flour and knives, it is mutually better for the former nation to interchange flour for knives, because of the greater relative advantage of each country in these respective lines. Foreign trade is therefore mutually helpful between countries differing in respect to the factors of production, as for example between countries of either unskilled or of skilled labor; of surplus or of inadequate capital; of abundant or of meagre natural resources.

The mercantilists drew a sharp distinction between national and international trade, but such a differentiation was not recognized by the later economists. The mercantilists regarded nations as more or less self-sufficient entities isolated by geographic distance and separated by supposedly fundamental differences such as language and religion. But these barriers are also present in national trade, as for example several thousand miles separate New York from San Francisco, while language and religion are different in Zurich and Geneva although both lie within the same country. Only as such factors restrict the free movement of labor and

capital between countries do differences arise between domestic and foreign trade.

Mercantilists and classicists differed further in their views on the importance of the trade in commodities in relation to the sum total of international economic dealings between nations. According to the former the account between one nation and all the others could be quite simply represented as either a favorable balance of trade in which exports of goods equal imports plus specie, or an unfavorable balance of trade in which exports equal imports of goods minus specie. Trade was thus considered merely an exchange of commodities and so did not include other items which actually enter into business relations between nations and which to-day are of greater value than the merchandise account. The term "trade" should therefore be defined more broadly so as to embrace not alone the dealings in material goods but also in intangible rights to capital and in services which are continually being bought and sold by the individual members of different countries. For the sake of clearness it is better to discard the term balance of trade entirely and instead to substitute the term balance of payments. Accordingly the equation of the international balance should be restated so as to read: total of credits equals total of debits. Thus each side of the equation is not composed of a single item, such as only merchandise, with specie

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on one side or the other depending on whether the balance is favorable or unfavorable, but rather of a number of items. Hence an increase in a single item on one side of the equation, such as exports of goods on the credit side, is not necessarily offset by the increase of gold on the debit side but by the augmenting of some other item such as capital on the debit side, assuming of course that the total of credits equal always the total debits.

MODERN THEORY ON THE EFFECT OF CAPITAL ON TRADE

Capital, as an item in the international balance of indebtedness, was of little importance before the Nineteenth Century. The economic significance of the international investment of capital was therefore not fully appreciated even by the classical economists, and only in recent years have observers of economic phenomena seriously studied the subject.

One principle concerning international capital which economists have so far developed has to do with its effect on trade. The relation between these two items in the international balance of payments may be illustrated by indicating the effects of both trading and lending operations on the balance sheet of two countries which are engaged in international business only with each other.

Assuming that two countries are buying and

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selling the same amount of commodities, their accounts will then read as follows:

COUNTRY A	
<i>Credits</i>	<i>Debits</i>
Goods exported, \$1,000,000,000	Goods imported, \$1,000,000,000

COUNTRY B	
<i>Credits</i>	<i>Debits</i>
Goods exported, \$1,000,000,000	Goods imported, \$1,000,000,000

Thus in each case, exports as credits offset imports as debits and so there is no balance either way.

In time, country A exports to country B goods to the value of \$100,000,000 more than it imports, and so country B has a debit of \$100,000,000 which it settles by exporting specie. In consequence, the respective balance sheets show the following entries:

COUNTRY A	
<i>Credits</i>	<i>Debits</i>
Goods exported, \$1,100,000,000	Goods imported, \$1,000,000,000
	Specie imported, 100,000,000

COUNTRY B	
<i>Credits</i>	<i>Debits</i>
Goods exported, \$1,000,000,000	Goods imported, \$1,100,000,000
Specie exported, 100,000,000	

Unless it produced precious metals, country B would in the long run encounter difficulty in exporting specie and so would eventually be forced to reduce imports to the amount of exports. Country A in order to continue the excess sales of its goods may follow the policy of not insisting upon payment in cash, but allowing B to retain this sum as a loan

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on such terms, as say 5 % per annum for a period of twenty years. Country A is thus transferring part of its purchasing power to B, but the latter applies it directly to the buying of goods from the former. Thus for the time being, country A obligates itself to pay a sum which becomes a debit against its account and country B receives it. Accordingly the account now stands as follows:

COUNTRY A			
<i>Credits</i>			<i>Debits</i>
Goods exported, \$1,100,000,000		Goods imported, \$1,000,000,000	
		Loans granted, 100,000,000	
COUNTRY B			
<i>Credits</i>			<i>Debits</i>
Goods exported, \$1,000,000,000		Goods imported, \$1,100,000,000	
Loans received, 100,000,000			

The granting of a loan, or "the exporting of capital" thus has the same effect upon the balance sheet of the grantor as importing goods, the only difference being that debits are increased permanently in the case of goods, and only temporarily in extending loans since they are cancelled eventually by repayment at maturity.

During the following year, country A continues to lend \$100,000,000, but country B is now faced with the necessity of paying an interest charge of \$5,000,000 on the loan of the previous year. By means of this loan, country B has been able to increase its production of goods and so makes payment by exporting an additional \$5,000,000 worth of goods.

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COUNTRY A

<i>Credits</i>		<i>Debits</i>	
Goods exported, \$1,100,000,000		Goods imported, \$1,005,000,000	
Interest received, 5,000,000		Loans granted, 100,000,000	

COUNTRY B

<i>Credits</i>		<i>Debits</i>	
Goods exported, \$1,005,000,000		Goods imported, \$1,100,000,000	
Loans received, 100,000,000		Interest paid, 5,000,000	

Thus the balance sheet is affected in just the opposite manner by the payment of the interest as by the investment of the original capital. For now the former lending country receives an item on its credit side to the amount of the interest and the previous borrowing country has a corresponding debit, whereas the two parties were in just the reverse positions when the loans were originally granted. Assuming now that country A continues to lend \$100,000,000 annually and country B pays the growing interest charge by steadily increasing its exports, the balance sheet at the end of twenty years will then read as follows:

COUNTRY A

<i>Credits</i>		<i>Debits</i>	
Goods exported, \$1,100,000,000		Goods imported, \$1,100,000,000	
Interest received, 100,000,000		Loans granted, 100,000,000	

COUNTRY B

<i>Credits</i>		<i>Debits</i>	
Goods exported, \$1,100,000,000		Goods imported, \$1,100,000,000	
Loans received, 100,000,000		Interest paid, 100,000,000	

The balance of trade thus stands in equilibrium, but in the next year country B must repay the first

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loan which it incurred twenty years ago. This may be accomplished by increasing exports to A in the amount of \$100,000,000 as indicated below:

COUNTRY A	
<i>Credits</i>	<i>Debits</i>
Goods imported, \$1,100,000,000	Goods exported, \$1,200,000,000
Interest received, 100,000,000	Loans granted, 100,000,000
Loans repaid, 100,000,000	

COUNTRY B	
<i>Credits</i>	<i>Debits</i>
Goods exported, \$1,200,000,000	Goods imported, \$1,100,000,000
Loans received, 100,000,000	Interest paid, 100,000,000
	Loans repaid, 100,000,000

It is thus seen that the repayment of a loan automatically affects the balance sheet in the same manner as the payment of interest while the loan is outstanding, for both transactions result in crediting the account of the country receiving the amounts and in debiting the account of the country paying out the sums.

From an analysis of the foregoing transactions certain conclusions can be drawn concerning the effect of capital investment on the trade of both the lending and the borrowing countries. When capital first starts to flow, the lending country tends to have a favorable balance of trade in that its exports exceed imports, while conversely the borrowing country has an unfavorable balance of trade in that imports are greater than exports. As indicated in the second transaction given above, there is a direct causal relationship between lending and trading

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operations, since the loan gives the borrowing country an additional buying power with which to obtain goods to an amount in excess of those which it can purchase by means of its own sales. As the lending country continues its foreign investments, the time will be reached when this outflow of new capital will be equalled and eventually surpassed by the rising tide of interest payments on former investments. Then the trade relations between the two countries will be completely reversed, for the lending country will have an unfavorable balance while the borrowing country will possess a favorable balance of trade. Thus the popular theory that a lending country has an excess of imports and a borrowing country an excess of exports holds true not in the beginning of the flow of international capital but only when the movement has been in progress for a considerable length of time.

SIGNIFICANCE OF THE BALANCE OF PAYMENTS

In recent years interest in the international balance of a country has widened considerably. Formerly it was analyzed only by a limited number of dealers in foreign exchange or students of foreign trade, but to-day it is carefully examined by business men and bankers, statesmen and economists. The balance sheet is studied not merely as a record which presents a mass of facts but as a statement which shows the present condition and future trend

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of the international business of a country. Just as the financial statement of a bank is read by interested persons, so the balance of payments of a country is considered by business men and economists for the purpose of drawing conclusions on such vital matters as the ability of foreign customer nations to buy goods or of debtor nations to pay their obligations. The international balance sheet is worthy of study even by persons concerned only in domestic affairs since these are affected by the fluctuations in foreign exchange, the international flow of gold and the changes in price levels abroad. As a basis for business and economic forecasting the international balance sheet of most countries possesses relatively less value than the statements of individual banks and industrial enterprises, since accurate data on most of the formers' items are not obtainable. Relatively complete records have been kept by governments on commodities cleared or entered at their seaports. The United States has issued its reports on commerce and navigation since 1821, and other maritime countries have maintained similar archives. These trade statistics indicating the movement of goods between countries obviously should verify one another but often the balances have not checked and errors are frequently uncovered by careful observers. On the other items in the balance sheet practically no official data have been compiled, and only in the case of some entries have financial

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institutions and other private organizations assembled information. Hence the amount of these items can be estimated only approximately and close calculation is out of the question. Thus fairly reliable statistics are available on the "visible" items such as goods and specie, while only indefinite data may be had for the invisible items of capital and services.

The sums which appear in governmental and private publications are merely the expressions of personal judgment which often cause wide variations in these estimates.

MEANING OF ITEMS

Before entering upon an analysis of the history of the international payments and the present balance of the United States, it will be well first to set forth in some detail the meaning of each item. The term "goods" requires no explanation, as it covers commodities such as foodstuffs, raw materials, and manufactures listed either as exports or imports, as well as gold and silver usually recorded as specie.

In both domestic and foreign business, capital is loaned either for a short or long period of time. Short-term or working capital is applied by borrowers to meet current needs such as the purchase of raw materials, while long-term or fixed capital is used to develop productive power such as the

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building of a new factory. The extending of temporary or short-term credit is the primary function of commercial banks, while investment institutions are concerned in the accumulation and placement of long-term credit. Besides, private investments of capital attracted by more favorable rates of interest abroad are also made in foreign properties without the intervention of any banking institution.

The international business dealings are usually considered as being conducted between individuals of one nation and those of another, and not, as the term international might employ, between nations as political bodies themselves. In the past such form of international business has seldom taken place, but mention may be made of the purchase on the part of the United States of Alaska from Russia and of the Philippines from Spain. Since 1914 international business in the sense of direct dealing between nations has become quite general due to the needs of war finance.

Reference has several times been made to services which, together with capital, constitute the invisible items in the balance of international payments. These services may be either commercial or non-commercial in nature. Most important of the commercial services, and moreover the largest invisible item after capital, is that of freights. They constitute the charges paid for the carriage of goods between countries. From the early days when the

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Greeks pushed their venturesome crafts across the Ægean Sea to the present time when the great trading countries operate mercantile fleets to all parts of the world, transportation costs have always been a vital factor in determining success or failure in international commerce. Another form of international business is the guaranteeing against losses by companies engaged in fire, marine, life, accident, and other forms of insurance. The payment of premiums on the part of the insured and the settlement of claims by the insurers in different countries involve large sums of money.

Banks are essentially institutions for performing special services such as the discounting of bills and the collecting of items, and while the charges on these individual transactions amount to only a fraction of one per cent, nevertheless before the war our business men paid from \$100,000,000 to \$150,000,000 annually to foreign banks and acceptance houses for such services. Other commercial services consist of brokerage commissions paid in order to place merchandise on foreign markets, royalty fees for the right to manufacture goods covered by foreign patent holders or to publish books or plays copyrighted abroad.

Among the noncommercial services in the balance of payments are included remittances sent by persons in one country as voluntary contributions to friends or relatives abroad in less fortunate circumstances.

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These remittances are usually transmitted in the form of postal money orders, but in the past few years they have been sent as cash in the form of either American dollars or food drafts which enabled the beneficiaries to obtain the necessities of life in countries where such supplies were scarce. In previous years most of these remittances were sent by individuals who were directly concerned in the welfare of the recipients, but since the war a growing proportion of these contributions is collected, transmitted, and even remitted by special relief organizations such as the American Relief Administration, The Society of Friends, The Red Cross, and the Jewish Joint Distribution Committee.

As a country prospers there is an increase in the number of persons who can afford the luxury of traveling in foreign lands. For this purpose millions of dollars are spent by tourists, especially from the United States. Besides, considerable sums are spent abroad by Americans who reside abroad. These persons may be either permanent foreign residents who prefer the social life abroad or they may be "birds of passage" who alternately work for a period of time in the new countries of North and South America and return home where their savings can afford them a good living until the next trip.

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THE BALANCE OF PAYMENTS OF THE UNITED STATES BEFORE 1914

Having described the various items in the balance of payments, it is well next to analyze the relative importance of these entries as they appear in the balance sheet of the United States. In a general way it may be said that the trade balance of this country before 1914 passed through the following cycles:

1. — 1789–1837.....unfavorable balance
2. — 1838–1849.....favorable balance
3. — 1850–1873.....unfavorable balance
4. — 1874–1914.....favorable balance

Since the total debits in the balance sheet must equal the total credits, these changes in the visible item of goods had to be compensated for by variations in the invisible items. During the early part of the first period, the United States paid for its excess imports by earnings derived during the Napoleonic conflict from its merchant marine, which in those days rivaled even the commercial fleet of Great Britain. The balance of trade became more unfavorable after 1820, but it was then offset by the influx of capital from Great Britain and Europe. These investments in the United States were seriously impaired by the panic of 1837 and its unsatisfactory financial aftermath. As a result, the tide of new investments declined and the continual interest payments on the old holdings reduced the American power to purchase goods from abroad, hence the

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decline in imports in proportion to exports and the consequent development of a favorable balance of trade. This condition proved but temporary, for the tide of foreign capital, attracted by relatively higher yields, once more flowed to America. The heavy production of gold after 1850 helped to pay for foreign goods and partly overcame the loss of revenue caused by the disappearance of the merchant marine during the Civil War.

Like the crisis of 1837, the panic of 1873 again changed the balance of trade to an excess of exports. Foreign lenders withheld their funds, and so our ability to purchase goods from abroad was curtailed, since these had to be met by stimulating the outflow of goods. With an improvement in economic conditions, foreign lending to the United States was renewed, but this force was offset by the growth in such debit items of services as freight charges for carriage in foreign vessels, expenditures of American tourists abroad, and remittances of immigrants to persons in their former homes. By these means an excess of exports was maintained until 1914.

BALANCE DURING THE WORLD WAR

However, this excess was declining steadily in the period just preceding the World War. The conflict caused a well nigh insatiable demand for raw materials and foodstuffs, and a curtailment in imports from the belligerent countries, so that by the close

BALANCE OF INTERNATIONAL PAYMENTS 25

of the war our excess of exports over imports exceeded \$11,800,000,000. This unprecedented balance was in part met by the belligerent countries through shipments of gold, and its net import during the war period exceeded \$1,000,000,000. Even this enormous sum left a balance of about \$10,800,000,000 still to be offset. This task was accomplished by the creation of credits with American banks in favor of the belligerent countries. Even before the outbreak of the war both Allied and Central powers, anticipating the impending conflict, resold large blocks of American rail and industrial securities to purchasers in the United States. In this manner American securities to the extent of over \$2,000,000,000 were returned to this country during the four years of the war.

Soon after the outbreak of the conflict the allied nations sought capital in the American money market and in time floated loans estimated at \$1,520,000,000. This method of establishing credits was employed until the United States entered the war in 1917, when the financing of the allied needs was assured by the American government, which granted direct advances totaling \$7,319,500,000.

BALANCE SINCE THE ARMISTICE

The annual balances of payments since the Armistice have been estimated as follows:¹

¹ *Commerce Reports, Trade Information Bulletin*, No. 215.

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BALANCE OF INTERNATIONAL PAYMENTS, 1919-1923

[Millions of dollars]

ITEMS	1919	1920	1921	1922	1923
CREDITS					
Current items, visible:					
Exports of merchandise (net).....	4,016	2,950	1,976	754	389
Exports of silver (net).....	152	26	.....	.....	.....
Exports of gold (net).....	160	.....	.....	.....	.....
Exports of United States currency (net).....	91	103	.....	.....	50
Current items, invisible:					
Interest on foreign investments (net).....	50	50	80	1351	1417
Ocean freight payments (net)....	93	93	33	7	.....
Total.....	4,562	3,222	2,089	1,112	856
Capital items:					
Foreign loans paid off ¹	515	571	255	78	23
Sales of securities to foreigners...	.....	.....	48	216	371
Principal of debts to United States Government.....	.....	.....	.....	31	91
Total.....	515	571	303	325	485
Total credits.....	5,077	3,793	2,392	1,437	1,341
DEBITS					
Current items, visible:					
Imports of silver (net).....	.....	.....	11	8	2
Imports of gold (net).....	.....	50	667	238	294
Imports of United States currency (net).....	.....	.....	100	.....	.....
Current items, invisible:					
Governmental expenditures abroad (net).....	2,375	305	50	16	19
Ocean freight payments (net)....	.....	.....	.....	.....	8
Immigrants' remittances (net) and charity.....	600	700	500	400	360
Tourists' expenditures (net)....	50	150	200	300	400
Total.....	3,025	1,205	1,528	962	1,083
Capital items:					
New foreign bond issues in the United States.....	436	506	665	637	377
Other foreign investments of American capital.....	534	939	427	326	33
Total.....	970	1,445	1,092	963	410
Total debits.....	3,995	2,650	2,620	1,925	1,493
Excess of credits (+) or debits (-) on current transactions.....	+1,537	+2,017	+561	+150	-227
Excess of credits or debits on capital transactions.....	-455	-874	-789	-638	+75
Excess of credits or debits on all transactions of the year.....	+1,092	+1,143	-228	-488	-152

¹ Includes interest received by United States Government from foreign Governments.

BALANCE OF INTERNATIONAL PAYMENTS 27

As seen from the above table, the export of goods exceeded the import in all five years, but at a declining ratio.

During the first five years of the post-war period, the net import of gold amounted to \$1,089,000,000, which was applied largely to the purchase of American goods.

Within the same period new securities were floated in the American market to the amount of \$2,621,000,000, from which however must be deducted \$1,443,000,000 of old issues maturing, thus leaving a net amount of but \$1,178,000,000. The movement of foreign holders to re-sell American securities to the United States was countered in 1921, 1922, and 1923 by the opposite tendency on the part of many foreigners to buy American issues. These buyers were influenced largely by the unsettled conditions in their own country and their consequent desire to place surplus funds in a currency which would not depreciate or which, in terms of their own money, would most likely appreciate in value.

After the close of hostilities the United States Government continued to grant direct advances to its war associates until the total was \$12,300,000,000. This outflow ceased after 1919 and in fact in 1922 the tide turned in the opposite direction with the initial payment by Great Britain of \$102,812,000 as interest on her share of the allied debt.

Pronounced tendencies may be noted in the items

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for services. Freight charges continued on the credit side of the balance sheet until 1923 when we paid out \$8,000,000 more than we received in ocean freights. Immigrant remittances show a sharp decline from the high point of \$700,000,000 in 1920 to but \$350,000,000 in 1923 due to some extent to the curtailment of immigration. On the other hand, tourist expenditures increased from \$140,000,000 in 1920 to about \$500,000,000 in 1922.

In summary, the United States has passed from the state of a debtor nation to that of a creditor country, and as she continues to export capital, an excess of imports over exports must be anticipated.

CHAPTER II

INTERNATIONAL CREDIT

DEVELOPMENT OF THE MEDIA OF EXCHANGE

The previous chapter has explained the various kinds of transactions which enter into international business. It was there seen that payments are effected between the individuals of different countries. When merchandise is bought, securities purchased, loans granted, cargoes carried, consignments insured, remittances sent, or when a variety of other services are performed, the mechanism or system by which these transactions are paid for is known as exchange. In the stage of local economy described above, people satisfied their wants by "swapping" or interchanging the goods which they possessed for those which they desired. This system of direct exchange was known as barter. It frequently happened that the party who possessed the desired goods was not willing to accept the articles offered by the other party, and so an interchange was often impossible. This and other disadvantages became greater as specialization in production developed when the period of local economy gave way before the stage of national economy.

Under these conditions a commodity such as gold or silver, possessing the necessary qualities of portability, divisibility, and stability of value, was introduced, and so the system of indirect exchange was evolved. Goods were no longer exchanged directly, but were then quoted in terms of this third unit known as money, which therefore served as a measure, or, as it was more generally known, as a standard, of value. If the price demanded by the seller was satisfactory to the prospective buyer and the goods changed hands, then money was said to perform the function of a medium of exchange.

As business developed and the stage of national economy was followed by that of international economy, exchange even by money proved inefficient, especially because of the difficulty and hazard involved in shipping precious metals over long distances. Therefore, business devised a third system of exchange through credit, which once more eliminated the use of money. In this sense credit has thus been a reversion to barter, but the two forms of exchange differ in that the former is an incompleted exchange since a credit transaction is closed not immediately but only after a lapse of time.

All three forms of exchange have been employed in international trade. For many years the "merchant adventurers" of England and of the European nations loaded their vessels with trinkets and like

goods which they bartered for furs and other valuable articles. Because of the disorganization of the money and credit systems in some countries, international barter has again been used, as for example the exchange of meat from Argentina for machinery from Germany (see p. 424). However, these cases are exceptional and barter in international business has long since been replaced by payments in money or in credit. Today an American buyer of British goods worth £1,000 may meet his obligation by purchasing the amount of gold bullion to this value and by shipping it to his creditor, but because of the wastefulness of this method of payment, it has been superseded in international as in domestic trade by the use of credit. This chapter will, therefore, be confined to an analysis of the nature of international credit, the function of the banker as a credit agent, and the forms of credit instruments. The presentation of these subjects will be largely theoretical, but these principles must be clearly grasped in order to understand fully the practical operations to be later considered.

FUNCTION OF THE INTERNATIONAL BANKER

Credit itself is intangible but it is evidenced in certain recognized documents known as credit instruments. These are substitutes for money and entitle the holder to payment in money. The method by which the holder obtains payment,

whether in domestic or in foreign business, may be explained by describing several transactions. Party A doing his business in City X, sells goods to B in City Y. Thus A as creditor has a demand claim upon B as debtor, but this claim is payable at a

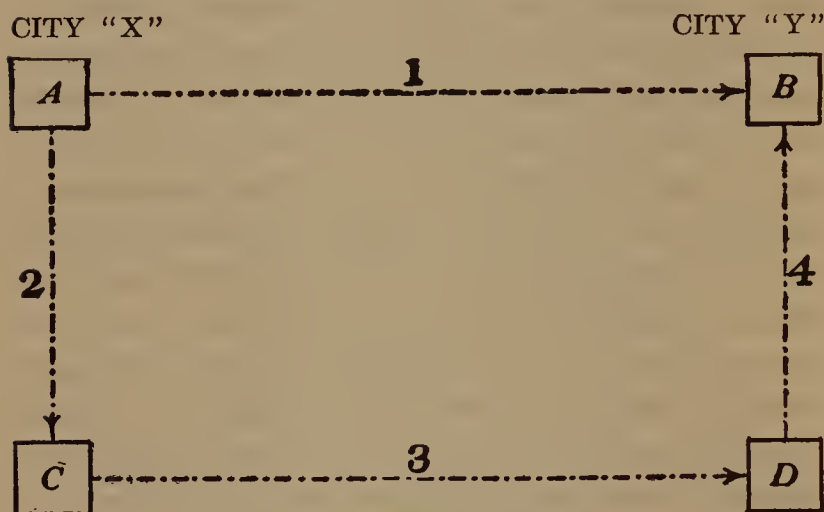


ILLUSTRATION 1

Direct Transfer of Funds

1. B gives evidence of his debt to A, his creditor
2. A transfers claim to C, his creditor
3. C transfers claim to D, his creditor
4. D obtains payment from B

distant point and not in A's locality, where he needs these funds to discharge his own debts. He must therefore seek someone in his own city who is willing to purchase a claim to payment in City Y. By chance he may find a party, possibly one of his own local creditors, who as debtor desires to effect payment for the identical sum of money to D, his

creditor in City Y, and who thus may obtain payment through B. This transfer may then be represented as illustrated on page 32.

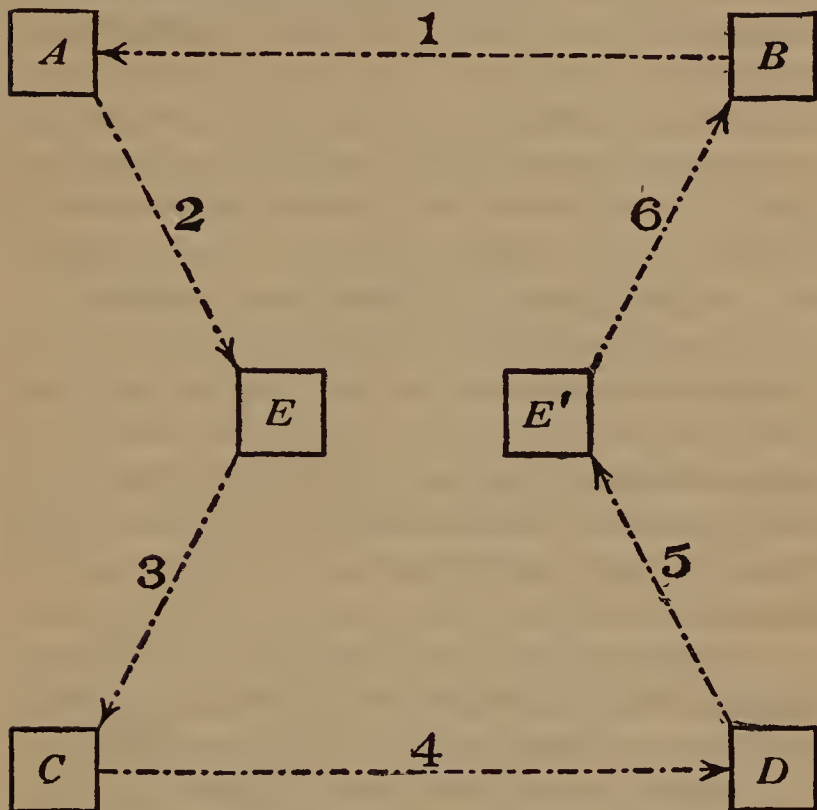


ILLUSTRATION 2

Indirect Transfer of Funds

1. B gives evidence of his debt to A
2. A sells claim to E
3. E sells claim to C
4. C transfers it to D
5. D obtains payment from E'
6. E' obtains reimbursement from B

However, such circumstances are not likely to exist all at one time, and so A will find it easier to

sell his claim to party E, a dealer who is engaged especially in that kind of business. At the same time, C of City X who wishes to purchase a claim to payment to D in City Y also approaches the dealer instead of trying to buy such a claim directly. In order to transfer these two claims between the two cities, the dealer must conduct a branch establishment of his own in both places or operate through a second dealer acting as agent or correspondent E'. In either case the claims are transferred to the proper parties, and for these services the dealer is entitled to compensation from both the seller and the buyer of the claims. This remuneration the dealer obtains by purchasing claims at a price lower than their face value and selling them at a higher figure. These transactions may be illustrated as shown on page 33.

So far it has been assumed that the claims are payable on a debtor who is well known and whose ability to pay is unquestioned. However, all debtors are not so fortunate and hence claims upon them would not always find a ready market. It is therefore necessary for the debtor to approach someone who is better known, and who for a charge will agree to pay the claims and later obtain reimbursement. Before this party will assume the obligation, he will first investigate the ability of the debtor to make repayment, and if satisfied the former will substitute his better-known ability to pay claims.

for the lesser-known capacity of the latter. The party who undertakes the obligation to pay the claim is thus acting both as guarantor for the original debtor, and as insurer against loss by the creditor. A party who performs these services is known in business as a banker. In addition he may also perform the function of dealer as described above.

DIFFERENCES BETWEEN DOMESTIC AND FOREIGN
EXCHANGE. — RESTRICTIONS ON FLOW OF
LABOR AND CAPITAL

Up to this point no distinction has been drawn between domestic and foreign exchange, as both are governed by the same principles. Since the time of Adam Smith, economists have recognized that exchange, in the broad sense of trade, is governed by the same general influences, whether for dealings between individuals of the same nation or between persons of different nations. As mentioned in the previous chapter, a distinction between national and international trade arises when greater mobility in the movement of labor and capital is permitted within a country than between countries. While the international flow of these agents of production has always been impeded by numerous obstacles, these have been further increased since 1914 by the public policies of most nations. The movement of population has been restricted by war-bled countries unwilling to lose their able-bodied citizens, while

other nations anticipating a surplusage of labor have restricted the immigration of foreigners. The movement of capital has also been subjected to limitations of various kinds. Most of the former belligerent countries, needing all their resources for the difficult task of reconstruction, have sought to check the exportation of capital, while others, fearing their economic conquest by alien interests, have tried to prevent the importation of foreign capital. Also tariff policies and embargoes to obstruct or prevent the entrance of foreign goods have been adopted quite generally even by countries which had long abandoned the protection system.

DIFFERENCES IN LAW

The operation of international business is rendered generally more difficult than domestic trade by sharp differences in law. True, state laws vary considerably within our country, but nevertheless interstate commerce is governed by general federal legislation. Business between nations is not subject to a similar supreme law and the commercial codes of countries present wide variations. In recent years there has been a growing movement toward uniformity in international legislation affecting commercial transactions. The adaptation of the Anglo-American system of law on bills and notes by a number of large countries, the acceptance of the York-Antwerp Rules on marine insurance and the

Hague Rules on bills of lading, have to a certain extent removed many of the legal obstacles which had hitherto impeded international trade. However, even greater progress is still needed to free foreign business of the burdensome restrictions from which domestic commerce has long been liberated.

DIFFERENCES IN CURRENCY

International business has always been more complicated than domestic in that the former involves payment in different kinds of money, while transactions within the United States are settled in dollars. In foreign trade this money must be converted into sterling, francs, marks or other currencies. These transformations were relatively simple before 1914 when most currency values were expressed in gold which served as a convenient common denominator. With the outbreak of the war, most countries abandoned the gold for the irredeemable paper standard and as a result their currency values lost stability, and conversion from one to the other became a difficult and highly speculative venture, with the possibilities of big profits or crushing losses. Under these conditions conservative business has hesitated to enter into foreign dealings.

DIFFERENCES IN CREDIT EXTENSION

In general, the element of risk has always been a greater factor in foreign than in domestic business,

due to the difficulty of obtaining reliable information on the paying ability of the debtors abroad. In the United States, banks and business houses extending short-term or commercial credit, have developed an efficient system of gathering and analyzing data concerning borrowers. They are expected to furnish detailed statements of their financial condition, which can be further verified by referring to various indirect sources well organized and capable of supplying valuable supplementary data. In foreign business, financial statements are rarely given and the other sources do not usually produce adequate credit data.

The weakness of the system of commercial credit information affects directly the class of short-term loans granted in foreign trade. The proportion of loans based on tangible security is greater in foreign than in domestic trade where the relative amount of pure credit or extensions of unsecured accommodation is considerable. Foreign loans may be collateralized by documents such as bills of lading giving the holder title over certain goods or securities evidencing ownership in certain properties. As a result, credit in foreign trade is extended to finance a particular transaction independently of all other dealings between the debtor and the creditor, while in domestic trade the latter usually gives the former a general line or maximum amount of credit of which he avails himself as needs arise.

Credit extensions in foreign and domestic trade differ not alone as to security but also as to maturity. The life of a loan is determined largely by the amount of time required for the completion of the underlying transaction so that the proceeds derived from the marketing of the goods can be applied to the payment of the loan. Foreign trade usually necessitates the movement of goods to distant points and so the period of marketing is generally longer than in domestic trade. Consequently, loans for the purpose of financing these transactions must be granted for a longer maturity.

The extension of credit in foreign and in domestic trade differs also as to the source from which it emanates. Credit according to its source may be grouped as either business or banking credit, depending upon whether it is extended by an individual or a firm on the one hand or a financial institution on the other. In domestic trade, a large proportion of business dealings are financed by business credit but it is a negligible factor in foreign trade. The dominant position of bank credit in foreign financing is due to the influence of some of the factors described above. In the first place, owing to the lack of credit information, business houses are unwilling to make advances to firms abroad and so there is need for the introduction of a foreign bank whose standing can be more readily ascertained. Also, the longer maturity of loans in foreign trade renders

it difficult for business houses to carry the entire burden of financing their ventures, and so they must look to banks for assistance.

COMMERCIAL CREDIT INSTRUMENTS

The increased importance of bank over business credit in turn leads to a difference in the forms of credit instruments used in foreign as against domestic trade. The simplest type of credit instrument is the open book or charge account which is merely an entry kept by a creditor to record the sums of money owed by his debtors. This simple method of evidencing claims can be employed only with debtors whose standing is well known and when business relations are very intimate. Otherwise the creditor may ask the debtor to acknowledge his indebtedness in the form of a definite promise to make payment and the credit instrument is then known as a promissory note. In the case of the promissory note the instrument is thus created by the debtor, but the obligation may also be recorded by the creditor in drawing what is known as a bill of exchange, or draft. This is an instrument in which the creditor orders the debtor to pay the debt to the former or to a third party whom he may designate. Thus a note is a promise to pay made by the debtor, while a bill of exchange is an order to pay drawn by the creditor. Both instruments may require payment immediately or at

some future date, and so are said to be payable either at sight or on time. A time bill of exchange is first presented to the debtor for his acknowledgment of the obligation, and after he has written his name and the word "accepted" or some other expression of similar meaning on the bill of exchange, it is then known as an acceptance. The acceptance is seldom used to evidence domestic credit in the United States where instead the open account and the promissory note are mainly employed. On the other hand, in foreign commercial credit transactions the open account and the promissory note are rarely found, while the bill of exchange is the prevailing instrument.

BANK CREDIT INSTRUMENTS

Since business credit is of minor importance in foreign trade, adequate consideration must be given to the instruments used by banks in extending credit. A bank may extend domestic credit either by issuing notes or creating deposits. Accepting the principle explained above that a bank functions by substituting its better-known credit for the lesser known credit of the individual borrower, let us assume that a bank grants him an advance of \$10,000 payable in ninety days. The bank may give him its own notes promising to make payment on demand to all holders. With these notes the customer is able to obtain services or purchase

goods from persons who otherwise would refuse to accept his undertaking to pay, but are now willing to take the promise of the bank because of its more widely known credit standing. However, this method of credit extension has everywhere declined in importance. In the United States, notes are issued outside of the Federal Reserve System only by National banks; in Great Britain banks no longer possess a legal right; and in most other countries this power has passed into the hands of the central bank or of the government. In the United States and Great Britain, bank credit is evidenced largely in the form of deposits. Thus the customer who obtained the loan of \$10,000, instead of receiving bank notes, could be allowed on the books of the bank a deposit credit to this amount. Against this deposit he could then give his creditor a check which is merely a bill of exchange drawn on a bank and ordering it to make payment on demand. As in the case of domestic credit, foreign credit is extended not by means of the note but by the bill of exchange. However, the bill of exchange is drawn in an entirely different manner. In the domestic transaction cited above, the check or bill of exchange was drawn on a bank by a depositor who as debtor was thus discharging his obligation to a creditor. While the same method could of course be used in foreign business, it is more customary for the bill of exchange to be drawn not by

the debtor but by the creditor on the bank which makes payment on behalf of the debtor. He could directly advise the foreign debtor to draw the draft but the question then arises whether the bank would actually make payment. This matter is settled in domestic business practice by having the bank certify payment, and in international business the problem is solved by the bank issuing its letter of credit. This is a special instrument addressed to the creditor, who is authorized to draw the draft on the bank, and the latter undertakes to accept or pay it when presented.

NATURE OF INTERNATIONAL INVESTMENT CREDIT

Most of the observations made above on the nature of short-term credit may also be applied to long-term or investment credit. The dominant motive which prompts an investor to send his capital abroad rather than keep it at home, is the attraction of a higher income yield. This in itself is a recognition of the fact that the element of risk is generally greater in foreign than in domestic business. As in the case of commercial credit, the cause of the greater element of uncertainty may be attributed in part to the lack of knowledge of foreign credit factors. True, this limitation is gradually being overcome by the improvement in communication among countries and the development of machinery for gathering credit data.

These shortcomings in the system of credit information influence directly the nature of foreign investment loans. It was noted above that because of the paucity of credit knowledge, foreign commercial loans are collateraled by actual property such as goods in transit or in a warehouse. Similarly investment loans are secured in a manner analogous to ordinary business paper. For example, when a lender is unwilling to grant credit on a note signed merely by a single borrower, he then obtains the endorsement of a second party who thus guarantees payment in case of default. Likewise foreign borrowers whose credit standing by itself is somewhat doubtful, frequently have their obligations endorsed by their own governments. From the standpoint of the grantors, as in commercial credit granting, the extension of foreign investment credit is largely in the hands of banks and not private firms.

CHAPTER III

CLASSES OF FOREIGN EXCHANGE

MEANINGS OF THE TERM "EXCHANGE"

In the two preceding chapters the term "exchange" has been employed in various ways. In its broadest interpretation exchange may include all the transactions of commerce whereby goods and services are transferred from sellers to buyers, and in this sense the term was used for the most part in the first chapter, which explained the kinds of transactions arising in international business. Again, exchange may refer, as shown in Chapter II, to the system of making payments or settling debts arising from these transactions. Exchange may be further limited to include merely the instruments representing claims to payment. In the narrowest interpretation the expression may refer simply to the price or rate at which these claims to payment are bought and sold. The last two interpretations will be used in this chapter.

GENERAL CLASSIFICATION

A bill of exchange as an order for payment may be drawn by or on either a banker or an individual

business man. There are then obviously four possible kinds of bills:

- (a) Bill drawn by a banker on a banker
- (b) Bill drawn by an individual on an individual
- (c) Bill drawn by an individual on a banker
- (d) Bill drawn by a banker on an individual.

The first type, of which both the drawer and the drawee are bankers, is consequently known as a banker's bill. Secondly, the trade bill is one to which both parties are not bankers but individuals. The third class, of which the drawer is an individual and the drawee is a banker, is called a commercial bill. The fourth class is of no practical interest since a banker does not draw a bill on an individual. Hence classified according to parties, there are three kinds of bills; bank, trade, and commercial bills. This classification differs from the usual statement that bills of exchange are either bank or trade, depending whether they are drawn upon a financial institution or a business house. This twofold grouping fails to recognize the commercial bill drawn by an individual on a banker, which type is used in financing a large proportion of foreign trade especially in connection with the letter of credit. (See Chapter XII, page 331.)

Regardless of the nature of the parties to the bill of exchange, it may be drawn so as to order the payment of a sum of money either immediately or

at a future date. According to this time element, known as the "usance" or "tenor" of bills of exchange, they may be further grouped as either sight or demand and time or date bills. Bankers', trade, and commercial bills, all may be drawn either at sight or on time.

BANK DRAFT

A bill of exchange drawn by one bank upon another and payable on demand is known as a bank draft. The making of such a draft implies that the drawer bank has a claim to payment in the form of a deposit balance with the drawee bank which may be either a branch office or a correspondent institution. On the strength of this deposit account, the creditor bank may thus draw a draft ordering the debtor bank to pay a certain sum of money to a third party whose name may be either directly specified or designated merely as "bearer."

POST REMITTANCE

A special form of bank draft is a "post remittance." A person desiring to send funds abroad to a friend or relative could forward him a draft purchased from an American bank and drawn on the latter's foreign branch or correspondent. The beneficiary or payee would obtain payment after making the proper indorsement on the draft and finding a

purchaser for it. This procedure although quite simple may prove inconvenient for a person having no business experience and living in a remote place. To overcome these difficulties and to facilitate the sending of small amounts abroad, the postal remittance or money order was created first by the American Express Company and later developed by the larger banks and also by the United States Government. Under this system the American bank sends an order to a foreign correspondent, which is then authorized to pay the beneficiary in actual cash. The correspondent usually performs this service by sending the beneficiary the sum in currency in an insured registered letter. In such countries as Italy, where the government has developed a careful system for the handling of remittances and savings through a network of post offices, foreign correspondents will then send postal money orders instead of cash.

An international or foreign postal money order may be obtained through a local office of the United States Post Office Department, which transmits the funds not through banking correspondents but through the postal systems of the foreign governments. Remittances through the post offices declined in importance after 1914, due to the fluctuations in the value of foreign currencies. The United States Post Office Department for a long time continued to quote the pre-war rates, although the

value of foreign currencies in terms of American money depreciated progressively. The post office tried to keep pace with these falling rates by now

2229 SERIAL NUMBER
STUB
DOLLARS
CENTS
AMOUNT FOR WHICH ISSUED

22905 Hagedorns Mills, N.Y.
OFFICE NUMBER
United States Postal Money Order
THE POSTMASTER AT
19--
SPECIMEN
WILL PAY AMOUNT STATED ABOVE TO ORDER OF PAYEE NAMED IN ATTACHED COUPON OR CASH NUMBER. IF ISSUED WITHIN THE CONTINENTAL UNITED STATES, ALASKA EXCEPTED, THE POSTMASTER AT ANY MONEY ORDER OFFICE IN THE CONTINENTAL UNITED STATES, ALASKA EXCEPTED, WILL PAY IF PRESENTED WITHIN THIRTY DAYS FROM DATE OF ISSUE
ISSUING OFFICE
STAMP HERE
RECEIVED PAYMENT
POSTMASTER

2229 SERIAL NUMBER
DOLLARS
CENTS
AMOUNT FOR WHICH ISSUED

TO BE DETACHED BY THE PAYEE OR PAYEE'S ATTORNEY WHO SHOULD PRESENT IT AT THE OFFICE OF ISSUE IF HE WISHES TO MAKE INQUIRY REGARDING THE ORDER

Hagedorns Mills, N.Y.
22905 OFFICE NUMBER
Coupon for Paying Office
NOT TO BE DETACHED BY HOLDER
2229 SERIAL NUMBER
RECEIPT
DOLLARS
CENTS
AMOUNT FOR WHICH ISSUED
TO BE DETACHED BY THE PURCHASER WHO SHOULD PRESENT IT AT THE OFFICE OF ISSUE IF HE WISHES TO MAKE INQUIRY REGARDING THE ORDER
ISSUING OFFICE
STAMP HERE

THIS MONEY ORDER IS NOT GOOD FOR MORE THAN LARGEST AMOUNT INDICATED ON LEFT-HAND MARGIN OF THE ORDER AND ANY ALTERATION OR ERASURE RENDERS IT VOID

ILLUSTRATION 3

United States Postal Money Order

and then issuing new schedules, but these were not revised fast enough and the rates quoted on foreign currencies were generally higher, and consequently dearer, in terms of dollars than those prevailing in the market. As a result, persons wishing to make

remittances naturally preferred to use the facilities offered by banking institutions.

LETTER OF DELEGATION

Quite similar to a money order is a document known as a letter of delegation. It differs from the draft and the money order in that it is not a negotiable instrument. It is simply a letter written by a bank to a foreign correspondent which is advised to pay a certain sum of money to a beneficiary. The letter of delegation was used during the war in remitting funds from the United States to persons in Central Europe, since all negotiable instruments transferring funds to these countries were declared contraband by the Allies and liable to seizure. The letter of delegation has thus been used as an instrument for transmitting funds only under abnormal circumstances. In the ordinary course of business before 1914 and since the return of peace, it has largely been applied to the creation of bank credits for purchasing goods, and so the instrument will be treated more fully in its relation to trade financing. (See page 360.)

CABLE TRANSFER

Similar to the money order is the cable transfer. It is simply another method for transmitting funds, but is distinctive in that the order is given by a banker to his correspondent by cable or wireless.

TO FOREIGN DEPARTMENT.

MECHANICS & METALS NATIONAL BANK,
NEW YORK CITY, N. Y.

GENTLEMEN: KINDLY EXECUTE THE FOLLOWING CABLE PAYMENT:

PLEASE WRITE PLAINLYPAYEE'S NAME John Doe
(GIVE FULL NAME)PAYEE'S ADDRESS 10 Russell Street
(STREET AND HOUSE NUMBER)
London
(VILLAGE, TOWN OR CITY)

(POST OFFICE)

(STATE OR PROVINCE)

England

(COUNTRY)

FOR ACCOUNT OF Richard Roe

BY ORDER OF

AMOUNT £1,000.0.0 @ 4.50 \$ 4500.CABLE CHARGES \$ 2.50WE ENCLOSE OUR CHECK FOR \$ 4502.50PLEASE DEBIT OUR ACCOUNT

CONDITIONS: In making this transfer it is understood and agreed that neither The Mechanics & Metals National Bank of the City of New York nor its correspondents shall be liable for any loss or damage occasioned by, delays or errors in the transmission or execution of the message by telegraph or cable companies, or by acts or omissions of any of its correspondents, or by mistakes as to the identity of the payee, or due to any other cause beyond the said bank's control, the risks of which are assumed by the undersigned. If for any reason payment is not effected, the said bank shall not be liable for any sum in excess of the market value in New York of the amount of this transfer current at the time of the refund thereof.

Yours truly,

Richard Roe

SIGNATURE

200 Wall Street, N.Y.C.

ADDRESS

ILLUSTRATION 4

Application for a Cable Transfer

In all other respects the cable transfer is similar in nature to the money order, for upon receipt of the order the correspondent bank makes payment to the beneficiary. It is thus seen that the transfer of credit by cable is not evidenced by a negotiable instrument but merely by an informal communication between the remitting bank and its correspondent. In this respect the transaction is like the transfer of credit by means of the money order or of the letter of delegation and unlike the transmission of funds by the sight draft. In the latter case the bank selling exchange gives the buyer a negotiable instrument which he then forwards to the beneficiary. Similar to the procedure in the case of the money order, the person desiring to remit funds by cable transfer fills out an application form (see illustration 4) addressed to the bank, which then gives him a receipt. This is held by the remitter, while the order for payment is forwarded by the bank.

There has been a greater increase actually and proportionately since 1914 in the use of cable transfers over all other forms of exchange. It was long used whenever banks or business houses wished to make immediate transmission of funds, but the mechanical improvements of the wireless have tended to increase the number of such transactions. Also disturbed political and economic conditions since 1914 have stimulated the use of trans-

fers over drafts. These instruments, forwarded by steamers, were often lost due to submarine attacks, preëmpatory search by military officers and the general disorder of the international mails. Since the close of the war the continual fluctuations in foreign currencies influenced the value of even sight drafts, which take at least ten days in transmission. This element of uncertainty is greatly reduced by the cable transfer, which often effects payment to the beneficiary within a few hours.

Cable transfers are sent in code in order to save the number of words and so reduce the cost. However, this charge is usually added to the price of the exchange, and so is carried by the remitter and not by the bank. The total cost of sending a cable transfer therefore includes the value of the exchange, the cost of the cable, the government tax, and the charge for the test word.

Thus far consideration has been given to the sight draft, money order, and cable transfer, which are forms of foreign exchange requiring payment on demand. On the other hand, banker's bills may also be drawn not on a sight but on a time basis, and calling for payment not on demand but on a specified date or on a certain number of days after presentation to the drawee. These date or time bills are said to be either short or long according to whether their maturity is less or more than thirty days. Short bills may run for any period from one

to thirty days, while long bills have a maturity usually of from sixty to one hundred twenty, but seldom over one hundred eighty days.

Drafts may also be grouped with respect to their purpose. In general the sight draft and the cable transfer are used largely for commercial transactions involving the payment of goods and services such as freight charges and insurance premiums, while the money order and the letter of delegation are both applied to the forwarding of remittances abroad. Time bills find their greatest use in transmitting either short- or long-term capital from one country to another, and may represent either secured or unsecured extensions of credit.

When a bank sells foreign exchange, it may thus evidence the transaction in the form of either sight draft, money order, or letter of delegation, but each instrument represents a transfer of a portion of a balance with a foreign correspondent from the credit of the bank to the credit of the individual. Without the intervention of any of these credit instruments, the claim over a foreign balance may be transferred from a bank to an individual. This step is often taken by persons speculating in foreign currencies. The low value of continental currencies tempted many with the possibilities of vast profits arising from a return to pre-war rates. Such speculation could be conducted by purchasing mark, kronen, and ruble notes outright and storing

them away in a safe place until the day of the anticipated rise. Others speculated by purchasing drafts drawn by banks on their foreign correspondents. These bills, whether sight or time, had a definite date of maturity and so proved inconvenient mechanisms for speculation especially when foreign exchange values became more and more unfavorable and the holder of the drafts desired to wait for a possible improvement in the rates of exchange. Under the law of some foreign countries, when the holder of a draft fails to present it within a reasonable time after its maturity, he loses recourse, or claim, on the drawer. Consequently an American bank, selling a draft to a customer who retains it past the date of maturity, cannot be held liable in the event of the failure of its foreign correspondent on whom the bill is drawn. A further disadvantage in foreign exchange speculation by means of both actual notes and drafts lies in the fact that the holder loses interest on such funds. In order to overcome these disadvantages, the speculator may through an American bank open a deposit account with a foreign bank which will pay interest. With the tightening of the money market, banks, particularly in Central Europe, have offered high rates in order to attract such balances. More favorable rates are of course granted on time accounts, which can be withdrawn only upon notice of a certain number of days given by the depositor to the bank,

than on balances against which checks can be drawn. These accounts are also opened, not only for speculative ventures, but also for ordinary business purposes by firms which have need of making continuous payments abroad. The case is analogous to that of a New York firm which has extensive business in Chicago and so instead of settling its obligations by drawing checks on its New York bank opens an account with a Chicago institution and draws against this balance.

The instrument thus drawn by the business firm on a foreign bank is a commercial bill which is similar in every respect to the domestic check. A check, whether drawn by a bank or an individual, implies the existence of an underlying deposit or balance against which it is drawn, and is thus distinguished from the ordinary bill of exchange. The type of commercial bill thus considered is drawn by the same party who has also opened the account with the drawee bank, but in certain kinds of transactions the commercial bill may be drawn on the bank by a party other than the opener of the account. This operation involves the issuing of a letter of credit which will be discussed in Chapter XII.

Trade bills are those drawn both by and on parties who are not bankers but individual business men or firms. Like bankers' bills, trade bills may be classified according to time, security, and purpose.

Trade bills may be either sight or time, and the latter in turn are either short or long, depending upon whether the maturity is less or more than thirty days. These bills may be documentary or clean, according to whether or not they are accompanied by collateral in the form of documents evidencing title to some form of property. Clean drafts are thus undocumented, and their worth depends solely on the credit standing of the drawee. Hence they are used only when the relations between drawer and drawee are very close, as for example an agent and a foreign insurance concern or a master of a vessel and the company. Such bills are clean, since they evidence the payment of international services which of course do not give rise to any documents. Documentary bills are drawn by a seller of merchandise or securities on the buyer, who receives them upon paying the bill. These documents may consist either of the regular commercial set, including the bill of lading, insurance policy and invoice, or of securities such as stocks and bonds.

The various forms of foreign exchange thus considered may be summarized as follows:

CLASSIFICATION OF FOREIGN EXCHANGE

PARTIES	TIME	PURPOSE	SECURITY
bankers	{ demand	money order	sale of
		letter of	remittances
		delegation	
		sight draft	sale of services
		cable transfer	goods
		advances	loan
	{ time	{ short	(secured)
			finance
		long	(unsecured)
commercial or trade	{ demand	sale of services	
	{ time	goods	clean
			documentary
		long	

RATES OF EXCHANGE

As foreign exchange is similar in its economic nature to any commodity, it therefore possesses a value which is known as the "rate of exchange." The exchange rate of the currency of any country is its value expressed in the money of any other country. The rate of exchange or the market value in normal times is closely related to the par of exchange or mint value as set by the respective governments. The ratio between two money units is easily determined when both countries employ the same monetary standard. Before 1914 the leading commercial countries of the world had adopted gold as the standard of value. Thus the British pound sterling possesses $113\frac{1}{625}$ grains of fine gold, while the American dollar contains 23.22 grains. Hence the par of exchange of sterling as

expressed in dollars was \$4.8665. In similar manner the pairs of exchange of francs, marks, or lires could be computed in terms of dollars.

EXCHANGE FLUCTUATIONS BEFORE THE WAR

Even in normal times the market value of foreign exchange showed fluctuations at certain times in the year either above or below the mint value, depending upon the market demand and supply of the bills of any currency as created by the movement of goods, the flow of capital and the payment of services. The effect of these forces is described in Willis and Edwards' *Business and Banking*, pp. 254-257, as follows:

"When American firms import goods from abroad, they may make payment through buying bills of exchange drawn on foreign countries. This demand tends to raise the value of the foreign currency as expressed in terms of United States money. On the other hand, when American traders export goods, they may draw drafts on British buyers or their banks. Thus a supply of sterling bills is created in the New York market and its rate is inclined to fall. Before 1914 these fluctuations occurred seasonally, for in May, when British exports to the United States were at their height, sterling often rose to about \$4.88, while in October, when American grain and other shipments to England were heaviest, the sovereign fell to \$4.84.

“The export and import of securities affect the rate of exchange in much the same way as the movement of goods. When American investors purchase British securities these may be paid for in sterling, and thus a demand for British exchange in New York is created, with a constant rising tendency in the rate of sterling. On the contrary, when British capitalists subscribe to an issue of Pennsylvania Railroad stock, it is purchased in New York, where the supply of sterling bills is increased, causing a decline in the rate of sterling. These transactions could also be settled in dollar exchange. British securities could be bought by remitting dollar drafts to London, where the supply would be increased and its value would fall in terms of sterling. Likewise the purchase of American securities could be made by British investors through buying dollar exchange in London and thus causing an appreciation in its rate as expressed in sterling.

“Dividend and interest payments would naturally cause a movement in exchange opposite from the investments themselves. For example, the semi-annual payment of dividends on the Pennsylvania stock mentioned above would naturally necessitate settlement by the American corporation with its creditors abroad. The American company could make this settlement by purchasing sterling bills, and this would tend to increase the demand in New

York, and so cause a rise in the price of sterling in terms of dollars.

“In the pre-war period the rate of sterling seldom fluctuated beyond these two limits, which were known as the gold points. A bill of exchange affords a claim upon a certain amount of gold, and it is generally more convenient and less costly to use this instrument than to ship bullion itself. However, if the price of the bill rises to an amount which exceeds the value of the gold plus the cost of its shipment, an American debtor who wishes to discharge an obligation in London would prefer to export the gold itself.

“The expense of transporting gold bullion between New York and London before the war was estimated at two cents per sovereign, and this amount included such items as abrasion, freight, insurance, brokerage charges, and loss of interest. Adding this sum to the par of exchange, the gold-export point was \$4.886. Conversely, the gold-import point on London was the par of exchange, \$4.866, minus \$.02, the cost of shipping gold, equaling \$4.846. When sterling bills fell below this rate, an American creditor who held claims on London would not wish to draw a draft and sell it at so low a quotation in New York, but preferred to have the gold itself shipped. Gold import and export points also operated in other countries with the gold standard, and so to same extent the rates on bills

of exchange for francs and marks moved within quite a narrow range. The international flow of currency and bullion was not entirely free even before 1914, for government control in most countries frequently restrained the export of gold."

CAUSES OF EXCHANGE FLUCTUATIONS SINCE 1914

Since the war the market values of most of the European exchanges have fallen to a fraction of their former value, due to the operation of certain forces which may be briefly described. Under normal conditions currencies on the gold standard are subject to little fluctuation. The free movement of gold, as explained above, makes it impossible for the exchanges to move below the lower gold point. But the moment a gold embargo act is passed by a nation, the exchange of that country becomes subject to many factors which either individually or combined will influence the exchange rate. The gold cover held by the central bank of issue has little effect upon the exchange rate of the country where a gold embargo act is in force. For example, at the end of August, 1923, the National Bank of Spain held in its vaults 2,526,000,000 gold pesetas, representing a cover of about 61 per cent of the total notes outstanding, and yet Spanish exchange decreased more than 30 per cent of its par value. The same phenomenon, although to a much smaller degree, may be observed in

Norway, Denmark, and in some of the other former neutral countries.

Thus, gold which under normal conditions is the most important factor in stabilizing the exchanges, has only little effect on the movement of exchanges, the moment a gold embargo act is passed. At present gold embargo acts are in force in almost all countries of the world, and the only free gold market is the United States.

If the balance of payment of one country is unfavorable and this deficit is not met by foreign loans, as a result more bills on this country are offered on the market than are demanded, and this condition in turn depresses the exchange rate. The fluctuation of the Swiss, Dutch and Swedish exchanges at certain times during 1919, 1920, 1921, and 1922 may largely be ascribed to this factor. Speculation affects mainly the weaker exchanges, but a point is reached in their decline where they finally fail to attract speculators as shown by the history of the mark and the ruble, and so if the exchange depreciates too much it is no longer traded in the international money markets.

The moment an exchange is off the gold standard it is very sensitive to all political and economic disturbances. The fluctuation of many exchanges in Europe is due to this factor. A good example of the effect of political events on the exchange rates is the influence of the capital levy proposal

on the Swiss franc at the end of 1922. Also the decline in the principal exchanges in Europe during 1923 owing in part to the uncertainty of the relations between Great Britain and France.

The flight of capital which influences exchange rates is also a direct result of political forces. Thus, for instance, the export of capital from Germany has been caused mainly by the uncertainty of the reparations question. One of the commonest forms of capital shifting is made by foreign exporters in accumulating balances abroad, mainly in the United States.

Exchange rates are also affected by the policy of the central bank of issue in a country. Most of the European governments suffer from huge budgetary deficits, which are met by discounting treasury notes with the central bank of issue. This institution in turn increases the amount of notes in circulation, and this policy is usually followed by an increase in the price level, which actually means a decrease in the purchasing power of the money. This decrease is immediately reflected in the quotations of the exchanges abroad. The movement of prices affects the exchange rates even of countries with sound currencies. Thus, for instance, an increase or decrease in the price level of Great Britain as compared with the United States will in time be reflected in the exchange quotation of the pound sterling.

METHODS OF QUOTING EXCHANGE

The rate of exchange or the price of foreign exchange may be quoted in various ways. Thus, in expressing the value of sterling it is said to be worth \$4.8665. This is known as the direct method of quoting exchange, since it indicates the number of home units (dollars) payable for one foreign unit (sterling). Conversely, according to the par of exchange, 5.1826 francs are worth one dollar. This is an indirect quotation, since it expresses the number of foreign units (franc) which can be commanded by one home unit (dollar). Any commodity may be quoted by these two methods. Thus, if one bushel of wheat is worth two dollars, obviously one dollar is the equal of one half bushel of wheat. However, the market prices of most goods, whether wheat or cotton, stocks or bonds, are all quoted in terms of dollars to simplify calculations. For many years the market prices of foreign exchange were quoted in both the direct and indirect methods, but in 1920 the dealers in the New York market agreed to employ only the direct quotation and in consequence all rates are expressed in terms of dollars and cents.

In addition to the direct and indirect methods, exchange may also be expressed by the discount and premium method. It is most effectively employed between two places or countries having the

same monetary unit. For example, one may read in the papers that domestic exchange on Chicago is selling in New York at a discount of ten cents, which statement means that New York banks will sell a sight draft for \$1000 against their accounts with Chicago institutions at \$999.90. Conversely, one may observe that on a certain day Canadian exchange is at a premium quoted at one per cent. Since Canada uses the dollar with the same mint par as the American monetary unit, a draft drawn by the First National Bank of Boston on the Toronto office of the Royal Bank of Canada will include this differential, and will amount to \$1010. In similar manner the premium and discount method is used in quoting rates between France and Italy, which employ the franc, and between England and Australia, both of which are on a sterling basis.

In recent years there has been a change in the method of indicating the progressive fluctuations in rates. For a long time this progression was expressed by fractions, so that when bankers wished to define the rate of sterling more sharply, they would quote it at \$4.86, $4.85\frac{7}{8}$, $4.85\frac{3}{4}$, $4.85\frac{5}{8}$, $4.85\frac{1}{2}$. To-day progression in most rates is carried out in decimals.

Quotations on foreign exchange are to be found on the financial page of the daily newspapers, and complete reviews of the market are given in the

weekly publications on business conditions. A comparison of the rates given by the newspapers of the same day will often show wide variations. Such discrepancies never arise in the prices of securities on the New York Stock Exchange. The high, low, and closing prices of all securities are recorded uniformly in all papers, since they are reporting transactions of a single organized market. As foreign exchange is bought and sold in an unorganized market, where no official records of dealings are kept, each newspaper must therefore obtain quotations from some large financial institution. The nearest approach to an official set of quotations on foreign exchange is issued daily by the Federal Reserve Bank of New York, which under the emergency tariff of 1921 is required to report each day the buying rate in New York for cable transfers on all important countries. Although the Bank under the Federal Reserve Act is permitted to buy such cable transfers, this power has never been exercised and it must obtain the quotations from dealers in the foreign exchange market.

CLASSES OF QUOTATIONS

In any market there are always two prices, the bid price offered by buyers and the asked price demanded by sellers. In the foreign exchange market the former is known as the buying rate at which a bank or dealer is willing to purchase bills

drawn on a certain country, and the latter is known as the selling rate. Thus the bid and the asked price, or the buying and the selling rate of a bank for, say, Belgium francs, may be quoted at 5.95 and 5.98 respectively. The difference between these two quotations is known as the spread and represents the bank's margin of profit on transactions in this currency when negotiated simultaneously.

On the stock exchange the same price is quoted for all transactions, whether large or small, except odd lots, and an investor may purchase one hundred shares of American Telegraph and Telephone stock at the same price as a buyer of one thousand shares. On the foreign exchange market the rates vary with the size of the transaction and the relative importance of the individual buyers and sellers. For large dealings in foreign exchange or for business houses with valuable accounts, banks quote what is known as an "actual" or wholesale rate, which is more favorable to the buyer or the seller than the "posted" or retail rate for smaller orders. Both the posted and actual quotations are known as "firm" rates, since they are real offers at which the bank is willing either to buy or sell. A bank also quotes "service" rates, which do not constitute true offers but are given over the telephone or in a printed bulletin merely for the benefit of customers desiring information on the general trend of the market.

FACTORS DETERMINING RATES ON VARIOUS CLASSES
OF BILLS

The value or market price of foreign exchange, like any other commodity, is not constant but variable. One important factor in determining the rates on the various classes of bills is the element of time. As the period of time between the drawing of the exchange and its payment is lengthened, the beneficiary is that much longer without the use of the funds and so loses a corresponding amount of interest. Conversely, as the maturity of foreign exchange bills is shortened, the funds are so much less available to the seller, who therefore charges a proportionately high rate. Consequently the rate on cable transfers is higher than that on sight drafts, which in turn cost more than sixty- or ninety-day drafts.

There is a difference of opinion as to whether the cable transfer or the sight draft is the basic or standard rate which determines all other rates. Some writers regard the cable transfer rate as the real exchange rate, on the ground that it involves no element of interest and so expresses the exact relative value of the various foreign exchanges at any one time. This view is taken by most foreign exchange traders but the opposite opinion is held by such writers as Furniss *Foreign Exchange* (page 85), and Whitaker *Foreign Exchange* (page 273). The

entire subject is one of academic rather than of practical interest.

A second factor is the credit risk. When bills are drawn on first-class banking institutions, the possibility of loss is so infinitesimal that there is no difference in the rates quoted on what is known as prime banker's bills, but lower rates are quoted on what are known as plain banker's bills. If an institution, even of good standing, permits too many bills to be drawn upon it, the value of such bills on the market will soon be adversely affected and they will sell at a lower rate. This is especially true when an excessive amount of bills, known as "pig on pork," are drawn by a bank on its foreign branch or on a closely affiliated institution. Such bills actually constitute only single-name paper, and may not bring quite as high a rate as two-name paper, of which the drawer and the drawee are separate institutions. Even these variations are very slight, for the credit factor is of relatively little importance in determining the rates on banker's bills. On the other hand, this element is the deciding factor in the case of trade bills which may be drawn either on firms whose standing is as sound as that of banks or on concerns whose reputation is extremely doubtful. Buyers of commercial bills are not usually in a position to ascertain the credit standing of the drawees and so look rather to the accompanying collateral. Its value will depend

largely upon the marketability of the commodity, so buyers of bills naturally prefer those drawn against such staples as cotton or grain.

The forces of supply and demand also affect the rates on the various classes of bills. A shortage of any one kind, such as cable transfers, will temporarily increase the relative value, but this situation quickly corrects itself since the higher rate soon brings a new supply on the market.

LEGAL NATURE OF FOREIGN EXCHANGE

Comparatively few decisions were rendered by the courts before 1914 on the subject of foreign exchange, since rates were steady and legal complications unusual. However, the sharp fluctuations in rates since 1914 naturally developed disputes among the parties to foreign exchange transactions and so created a mass of litigation. The decisions in these cases express several interesting legal theories on the nature of foreign exchange and the relations among parties to an exchange transaction.

In the preceding pages it has several times been shown that foreign exchange has the same economic nature as a commodity. This theory is accepted by the Appellate Division of the Supreme Court of the State of New York in *Legniti vs. Mechanics and Metals National Bank* (186 App. Div. 112), which states that: "Foreign exchange is a subject of purchase and sale and not only may be, but is

commonly contracted for in the same manner and governed by the same laws as in the case of the purchase of wheat, cotton or any other subject of commerce.”

While this theory which regards foreign exchange as a commodity is undoubtedly sound in economics, it has at times been misapplied in law, as by the lower court in *Strohmeyer vs. Guaranty Trust Company* (172 App. Div. 16). The plaintiff had instructed the defendant to remit to a party in Genoa by cable the sum of 75,000 lire and paid \$14,423.08 as the price of the cable transfer in New York City on October 23, 1914. The bank in a written acknowledgment accepted the order and agreed to make payment through its correspondent, the Credito Italiano. The Guaranty Trust Company gave the cable message to the cable company, which failed to deliver it. On November 9, Strohmeyer notified the bank that the money had not been paid and so it again cabled the order, which on November 11 was finally paid. Meantime lire exchange had fallen, so that on November 11 the market value of a cable transfer of 75,000 lire was but \$13,929.54, and hence the plaintiff sought to recover the difference of \$493.54. The lower court decided in his favor upon the theory “that what defendant contracted to transact was the identical money paid to it by the plaintiff [individual sending the funds], likening the case to one in which a

common carrier had received ten trunks for transmission and delivered only nine of them. The court was therefore of the opinion that the money paid to the defendant remained the property of the plaintiff until it or its equivalent had actually been paid over in Genoa and that all the plaintiff was entitled to retain was the value in New York on November 11th at the current rate of exchange for cable transfers, of 75,000 in lire in Genoa" (*Ibid.*, p. 20). This view was rejected by the higher court in the following words: "This decision rests upon an erroneous view of the nature of a cable transfer, and the supposed analogy of a common carrier transmitting merchandise is not appropriate, for there is no failure to deliver in Genoa the 75,000 lire contracted for, but only a delay in making such delivery. The term 'cable transfer' precludes the idea that an actual transmission of money is contemplated . . . what the buyer does is to purchase a credit available at such place." (*Ibid.*, p. 20.)

The court overlooked entirely a practical aspect of the question which would have further supported the contention of the defending bank. This institution on selling 75,000 lire most likely covered the transaction in buying exchange for the same amount. Hence it did not profit by a fall in lire, unless it had adopted a short position on lire, in which case it would have been entitled to the speculative profit. Other decisions rendered by

American courts in cases relating to the transmission of funds have recognized clearly that a foreign exchange operation does not imply the transfer of actual money but rather of credit. The development of this credit mechanism is well explained by the court in the case of *Legniti vs. Mechanics and Metals Bank*, as follows:

"This practice of selling credit by means of drafts or checks grew up among merchants and bankers with the expansion of trade and the necessities of commerce. With the increase of foreign trade and the development of international relationships, communication by cable and wireless met the insistent demands for haste and dispatch. Thus the custom has developed of selling credit to be established by cable or wireless. A purchaser does not receive a draft or check which will be given him in the foreign country by an immediate cable or wireless from the seller to his correspondent at the foreign point. The thing sold is the same in the case of the cable or wireless transaction as in the case of the draft or check. It is the credit of the bank or seller. The means of establishing or transmitting the credit is simply an incident of the transaction. In the one case, it is a formal paper drawn up and signed by the seller directing his foreign correspondent to make payment of the amount and to the person therein stated. In the other case, it is a similar direction transmitted by cable or wireless. Cable transfers, therefore, mean a method of transmitting money by cable wherein the seller engages that he has the balance at the point on which the payment is ordered, and that on receipt of the cable directing the transfer his correspondent at such point will make payment to the beneficiary described in the cable."

According to this line of legal reasoning, the buyer of foreign exchange is not purchasing cash but instead a certain amount of credit which is made

available at some distant point. The value of this credit is not guaranteed, for it varies with the state of the market.¹ This viewpoint is consistent with the decisions which have been rendered during the past fifty years on the legal relation between depositors and bankers in domestic business (see Morse on *Banks and Banking*, fifth edition 1917, section 567, also article in *Columbia Law Review*, June 1921, p. 513, Willis and Edwards, *Business and Banking*, pp. 95-97). A banker may receive either special or general deposits. A special deposit must be kept by the banker in a safe place and returned unimpaired to the depositor at his call. The relation between the two parties is then more or less fiduciary in nature and the banker acts as trustee. In the case of an ordinary or general deposit, the banker serves rather in the capacity of debtor for a certain sum in favor of the depositor, who thus stands in the position of creditor. Title to a special deposit remains always with depositor, but the ownership of a general deposit is transferred to the banker,² who may mingle it with his other assets.

¹ This view is not followed by the Court in *Chemical National Bank vs. Equitable Trust Co.* (194 N.Y.S. 177).

² For analysis of recent British legal decisions on foreign exchange, see *Journal Institute of Bankers*, Jan. 1924, p. 35.

CHAPTER IV

FOREIGN EXCHANGE MARKET

The previous chapter on the various classes of bills of exchange has presented the subject from a rather static approach. The next step is to examine from the dynamic viewpoint the actual handling of these bills in the market and the real operation of the foreign exchange transactions.

NATURE OF THE FOREIGN EXCHANGE MARKET

Foreign exchange in the sense of a credit instrument, expressing a claim of a creditor on a debtor, possesses all the general economic characteristics of any commodity or good. As such, foreign exchange is freely bought and sold and its price is subject to the economic law of supply and demand. In common with other goods, dealings in foreign exchange are made in a market where buyers and sellers are brought together, and as a result, a market price, which is approximately uniform, prevails at any one time in the period of trading.

However, foreign exchange differs in nature from staple commodities such as wheat or cotton, which are traded in organized markets, as the Board of Trade in Chicago or the Cotton Exchange in New

York. There buyers and sellers of these commodities come together and conduct their operations under a set of regulations, and hence such exchanges are known as organized markets. Similar organized markets for dealings in foreign exchange, usually associated with the local stock exchange, exist in most of the Continental money centers, as Paris, Berlin, Amsterdam, and Copenhagen. In New York and even in London there is no central place for foreign exchange trading, and so dealings are completed without any formal regulation. Hence it may be said that foreign exchange in New York is bought and sold in an unorganized rather than an organized market. An unorganized market is not necessarily disorganized in its operation. In fact, this method of conducting a market is applied with efficiency in other business fields, such as the commercial paper market where promissory notes in a daily volume of millions of dollars are freely bought and sold. Although buyers and sellers of foreign exchange do not come together in direct personal contact, nevertheless they are in close communication over the telephone. Private wires bind together the more important traders, and dealings in foreign exchange can be completed almost instantaneously. New York City, as the center for the foreign exchange dealings of the United States, receives orders over long distance telephone and telegraph from Boston, Chicago, Cleveland, St. Louis,

and New Orleans, and even San Francisco looks to New York, where the market is made for Far Eastern exchange.

PARTIES IN THE MARKET

As the foreign exchange market is thus in technical economic terminology unorganized, buyers and sellers cannot be as sharply defined as in the case of an organized market such as a Stock Exchange. The members of this exchange are either brokers or dealers. The former in buying or selling securities act as agents for other parties and receive a commission for such services. Dealers who are really bankers buy and sell securities not for someone else on a commission basis but for their own account and for the profit which they may obtain out of such transactions. In similar manner, operations on the foreign exchange market are conducted by brokers and dealers. The former have only very limited capital and credit, while the latter being generally bankers are not so restricted and are therefore better able to engage in transactions which require the carrying of foreign exchange over a period of time. Another distinction lies in the fact that brokers operate mainly with banking institutions, while these, as dealers, conduct their transactions largely with business houses which because of their commercial needs must trade in exchange. Foreign exchange is bought and sold by the various

banking institutions interested in foreign finance as described later in Chapter V. An important operation of these banks is the buying of foreign exchange for their own customers or those of correspondent banks desiring funds abroad to cover traveling expenses, to send remittances, to purchase foreign securities, or to buy foreign goods. Large firms and corporations engaged continually in international business transactions relating to merchandise, securities, freight, or insurance find it advantageous to buy and sell foreign exchange directly. Thus the three groups in the foreign exchange market are brokerage firms, banking institutions and business houses.

From this description it is evident that the New York foreign exchange market when compared with an organized market such as the Stock Exchange is still in a relatively undeveloped stage. This condition can be explained by the fact that the market has had but a short history. Before 1914 few foreign exchange transactions were negotiated in New York where not more than a half dozen banks were interested in foreign finance. This number increased manifold after 1914 with the heavy pressure of war exports, and even after 1919 with the wild speculation in depreciated foreign currencies. In order to bring about some uniformity in market practices, a group of officers in several New York banks organized an informal body known as the

Foreign Exchange Club. It is quite possible that the foreign exchange market in the near future will be developed into a more formal state. Various plans for accomplishing this end may be suggested. Foreign exchange dealers and the authorities of the New York Stock Exchange have considered the possibility of conducting operations under the administration of the latter institution, as in some European centers. Little progress has so far been made in this direction because of the opposition of the dealers. It would seem that the clearing principle which has worked so successfully in handling securities, checks, and collection items could well be applied to foreign exchange dealings, which could then be settled through a clearing house association.

A less formal plan could be followed, such as that of the Shanghai Exchange Brokers Association. This organization issues at the opening of business a daily bulletin quoting rates on London, New York, Hongkong, Japan, and other money centers dealing in Far Eastern exchange. This list serves as a basis for negotiating bills, though of course actual business may be transacted at several points above or below these quotations.

TRADING POLICIES

A banker engaged in foreign exchange dealing may be regarded as a middleman between one party who wishes to sell a draft and a second who

wishes to buy it. However, it must not be thought that he resells the identical bill which he has bought. This conception is just as erroneous as the popular theory that the function of a banker is to receive funds from depositors and to lend these very sums to borrowers. The banker engaged in trading operations buys various kinds of exchange, forwards them to his foreign correspondents, which credit these amounts to his account and thereby his balances abroad are created. Against these balances he draws his draft each time that he makes a sale of exchange. The banker buys commercial and trade bills drawn on foreign banks and business houses, and on these as a basis he sells drafts drawn by him on balances with his correspondents. Thus balances are built up by the purchase of commercial and trade drafts and are reduced by the sale of banker's bills.

The trading operations of banks may be dictated either by a conservative or by a speculative policy. Some banks enter the foreign exchange market solely for the purpose of meeting their own immediate needs and those of their clients. Each purchase of exchange is promptly covered by a sale, or conversely each sale by a purchase, and through this policy of hedging the element of risk is greatly reduced. This factor cannot be eliminated entirely because of the unorganized nature of the foreign market, and so purchases and sales actually cannot

be made simultaneously. As the period of time between a purchase and a sale is lengthened, the speculative risk is correspondingly increased. Within this period the officer who is performing the trading operations for the bank may "take a position" by going either long or short on one or more of the foreign exchanges. Thus he either buys a certain amount of sterling, francs or lire in the expectation of a rise in their value at a later date when he will sell out, or he sells these exchanges short in anticipation of a fall in their value at a later time when he hopes to buy them back. Banks regard it as a wise rule not to maintain a position for longer than a day, and before the trading is over it is the better part of discretion to have a "level" book in which sales offset purchases, even though such a policy may force the bank to take a loss. This policy is not always followed by more venturesome traders, who feel confident of their judgment on the future trend of the market, and so carry a long or short position for a considerable length of time. Banks are tempted into such policies in times when their other activities are dull and not lucrative, and when they wish to recoup themselves by profits in exchange speculation. Bad judgment or poor guesswork on the part of traders has often brought severe embarrassment to banks. Such losses have been far less serious in the case of American banks whose foreign exchange dealings

are, after all, only incidental to their other operations, than in the case of Continental banks which are forced to engage in trading on a large scale because of the instability of the currencies in which they and their customers are conducting all their business.

RECORDS FOR EXCHANGE TRADING

At best, all foreign exchange operations involve a certain amount of risk, but this factor can partly be reduced by the maintenance of accurate records. At the close of each day's business, entries should be made of all purchases and sales and the net difference should be stated on a position sheet so that the trader may readily ascertain the balances to the credit of the bank with each of its correspondents. The trader must know the size of these balances not alone at the present but also at any given time in the immediate future, and so he is given two position sheets, one for cable transfers and the other for sight drafts.

Another record to aid the trader in his operations is the parity sheet, which indicates current rates. The European money markets are in operation for several hours before the opening of business in New York, and it is possible for American traders to receive these cable quotations. They are tabulated on the parity sheet, which is continually replaced by new sheets as the cable and wireless

reports indicate important changes. In addition to recording rates of exchange, the parity sheet also shows the rates of discount of the central banks in the various money centers of the world.

Thus at a glance the trader is able to follow the trend of the various exchanges, for his market is confined not to a single trading room, as the New York Stock Exchange, but world-wide in scope it includes such different centers as London and Shanghai, Amsterdam and Buenos Ayres.

A third record is the contract on which are entered the details of each individual exchange transaction. It is not a formal document signed by the parties to a purchase or sale of foreign exchange, but merely a memorandum kept by the bank or the broker to summarize the facts of a deal which may have been negotiated over the telephone or by wire. Contracts are of three kinds, depending on the time of delivery. The exchange may call for spot currency on the same day, prompt delivery or within a few days, future delivery or at a definite date of, say, 30, 60, or 90 days.

FUTURE EXCHANGE

In the discussion of buying and selling foreign exchange, it has so far been assumed that these transactions have been made for "spot" or immediate delivery. As in the case of cotton or wheat, foreign exchange may also be bought or sold for

“future delivery.” Future operations, whether in cotton or in foreign exchange, enable persons either to transfer or assume the risk arising from fluctuations in prices. Thus a New England manufacturer may protect himself against an increase in the price of cotton by purchasing it in the spring for delivery in the fall. He is thus better able to determine his cost of production and the price of the finished good without bearing the risk of an increase in his outlay for raw material. This hazard is carried by the speculator, who really sells short but agrees to deliver cotton for a fixed price at a future date, regardless of the market at that time. A similar future operation may take place in foreign exchange. Transactions in international trade, like those in domestic business, are seldom closed immediately and so a time element of varying length intervenes between the beginning of a transaction and its ultimate settlement. Consequently, the manufacturer who is selling his goods in a foreign market not only assumes the attendant risks of the trade, but also the risk of exchange. Suppose that he has agreed to manufacture a certain number of motor trucks for £10,000 and, at the time when this contract was made, sterling was quoted at \$4.70, so he expected to receive \$47,000. When the automobiles were delivered and payment was made, sterling had fallen to \$4.60 and so he received but \$46,000. This loss of \$1,000 may have absorbed

a large part of the entire profit which he derived from the manufacture of the trucks. In order to protect himself from such fluctuations, a manufacturer or a merchant may sell future exchange and so shift this element of risk to a speculator.

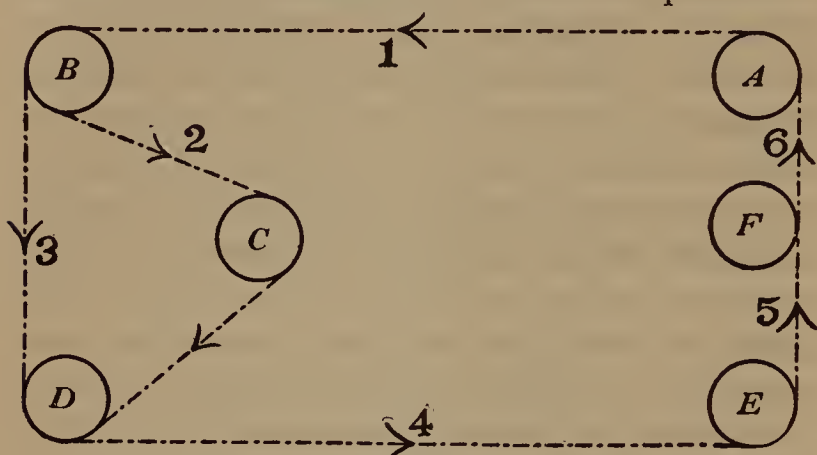


ILLUSTRATION 5

Transaction in Future Exchange

- A. British importer
- B. American exporter
- C. Foreign exchange broker
- D. American bank
- E. London correspondent bank
- F. British drawee bank

Such a transaction in future exchange involves the following operations, which are illustrated by the above chart.

(1) Assume that the manufacturer, mentioned above, in April has agreed to sell to the British buyer the motor trucks for \$47,000 at the prevailing rate of \$4.70 for £10,000 to be delivered in July.

(2) The manufacturer immediately communicates with a foreign exchange broker in order to sell his claim on £10,000 in July. Through the broker this future exchange is sold to a bank engaged in foreign exchange transactions.

(3) In July the American manufacturer ships the automobiles, draws his draft on a British bank designated by the purchaser of the goods, and delivers the draft to the American bank which in April had agreed to take it.

(4) The American bank then sends the draft to its London correspondent.

(5) The London correspondent presents the draft to the drawee bank either for payment or acceptance.

(6) This institution then obtains reimbursement from the importer.

DEVELOPMENT OF FUTURE TRADING

Trading in future, or "forward" exchange, as it is known in England, existed before 1914. It was possible to obtain future quotations on dollars and sterling, but these transactions were few in number since rates rarely fluctuated more than one per cent above or below the mint pars. Even these changes could to a certain extent be anticipated, since they were due to seasonable movements of goods which flowed to England in the fall of the year so increased the value of the dollar, and in the spring depressed it by a contrary movement.

Extensive transactions in future exchange before 1914 were confined largely to the Far East, where currencies had not attained stability.

Operations in future exchange did not assume general importance until 1919, which year marked the beginning of the erratic fluctuations in the European currencies. During the war they had been "pegged" or artificially maintained at a constant level, but with the unpegging or withdrawal of support these currencies, including sterling, suffered sharp declines. To protect themselves against losses arising from such changes, conservative merchants and business men who were to receive payment for the selling of goods or the performance of services, or who had to make payment for purchasing goods or obtaining services, either sold or bought future exchange and the risk was, therefore, transferred to speculators.

EXCHANGE SPECULATION

In the older and more organized markets these risks are carried by persons who make speculation their profession and are well informed on the factors influencing the trend of prices. Since 1919 speculative operations in foreign exchange have to a considerable extent been made by masses of people ignorant even of the rudimentary principles of exchange, and so their losses have been severe. It is commonly believed that speculation has been a

most potent cause for the present instability of foreign exchange. No less authority than Dr. F. Giannini, financial attaché to the Italian embassy in London and delegate to the committee of experts at the Genoa conference, in the Reconstruction Number in the *Manchester Guardian* (p. 25) writes as follows:

“Speculation, that is the purchase and the resale of currencies without accompanying commercial transactions, for the purpose of realizing the difference between the quotations at two different periods, adds to the momentum of supply and demand that of a considerable mass of dead bills, bills which are not the instruments of commercial transactions. They contribute largely to the fluctuation of the exchanges and as speculation concentrates particularly on those currencies with the greatest fluctuations its action makes more frequent and more acute the movement of these exchanges which are already, for other reasons, subject to special instability.”

There is no doubt that the mass of uninformed speculators who blindly bought foreign currencies in 1921 and who desperately threw them on the market in 1922 forced rates to unduly high and low points. Such ill advised speculation should be discouraged, for it only accentuates price changes. On the other hand, professional speculation by individuals or banking institutions better informed on the possible future course of exchange tends to narrow the range of fluctuations. Several European governments in response to popular outcry have tried curbing professional speculation in the hope of preventing excessive fluctuations. Such policy has

just the opposite result, for the greatest fluctuations occur in those exchanges which are subject to government regulation. Until the exchanges are stabilized, a system of free and organized speculation is essential in order to shift the exchange risk from merchants and manufacturers who should be concerned primarily in the commercial hazards of their own business to specialists who are better qualified to judge the trend of exchange.

ANTWERP FORWARD EXCHANGE MARKET

As explained at the beginning of this chapter, foreign exchange trading in the more important European money centers is conducted on the local stock exchange. Because of the importance of forward exchange in minimizing rate fluctuations, efforts have been made to develop a better organization for dealing in this type of exchange. In 1920 the first attempt in this direction was made by business interests of Antwerp which because of its seaport activities had long been an important foreign exchange center. This city before the war had developed a highly efficient system of guaranteeing the settlement of future contracts in such commodities as coffee and rubber. After the war, local merchants experienced difficulty in obtaining satisfactory future contracts for their foreign exchange needs. The Antwerp Chamber of Commerce therefore applied with certain modifications the system

of handling future contracts in commodities to dealings in foreign exchange. As a result the "Caisse Internationale de liquidation et de Garantie des operations en Marchandises" (International market for the settlement and guarantee of transactions in commodities) was established.

Because of its unique nature and of the possibility of extending the system, the operation of this institution deserves explanation. The organization is conducted for the purpose of bringing together buyers and sellers of future contracts in foreign exchange. It is open only to Antwerp merchants and bankers, but they in turn may act for non-residents who by themselves would not be qualified to have direct representation on the market. The institution operates on the clearing principle and in some respects is similar in nature to the Stock Clearing Corporation of the New York Stock Exchange. Dealings on the forward exchange market are standardized as to class of exchange, amount of money, and time of delivery. The sales and purchases are confined to future contracts in American dollars, pounds sterling, Dutch guilders, and French francs. In each case the standard unit of the future contract is as follows: \$3,000, £1,000, Glds. 5,000, Fcs. 25,000. Thus bids and offers are made not for odd amounts but in round numbers of, say, 1, 3, 5, or 10 units of dollars, sterling, guilders, or francs. Likewise the future date for the comple-

tion of the contract and the actual delivery of the exchange is set at fixed periods of time. Thus future contracts are assumed for delivery of exchange on the beginning and middle of each of the coming six months. The variable factor, of course, is the quotation, which depends on the state of the foreign exchange market.

Under these conditions, a transaction is operated as follows: An Antwerp merchant undertakes to buy goods at a price of £1,000 from a British exporter and agrees to make payment in three months' time. In order to avoid loss from a rise in the price of sterling in relation to Belgian francs, the Antwerp merchant will place his bid for future sterling exchange on the market where some other business man or a banker acts as seller. Before the due date of the contract, the seller will give the "Caisse Internationale" a check on London. For guilders or francs, checks are drawn on Amsterdam or on Paris, but for the completion of dollar contracts, because of the greater distance, cable transfers on New York are required. (See also *Commerce Reports*, Nov. 26, 1920, pp. 890-891.)

This system works more to the advantage of business houses than banks, since the former are able to satisfy their exchange needs at more favorable terms than if they approached the banking houses directly. The adoption of this plan has been considered by Paris business interests de-

sirous of enhancing the importance of their city as a foreign exchange market.

ARBITRAGE IN GENERAL

With the development of international business, certain commodities were bought and sold not alone in one but in several countries. So in time international dealings were conducted in staple commodities such as cotton, grain, and pig iron, in high-grade stocks or bonds, in bullion and in foreign exchange. In a way it may be said that each of these commodities possesses an international market, but their prices do not move up or down in the same close relationship as would occur if trading were conducted in one place. Although these commodities theoretically have a world market, actually they are traded in several markets. However, prices in these markets are maintained at a comparatively close relationship by what is known as arbitrage or arbitration transactions. These are performed by international traders who seek profit from price variations in the same commodity in different markets. Arbitrage is therefore unlike speculation, which is a transaction conducted to obtain profit from price variations of a commodity in the same market but at different times, while arbitrage is an operation undertaken to derive gain from the price variation of a good in several markets at the same time. Pure arbitrage therefore implies

instantaneous or rather simultaneous action. Theoretically the element of time should be eliminated from arbitrage, but actually it is always present and so arbitrage necessarily involves a certain amount of speculation.

ARBITRAGE IN EXCHANGE

As mentioned above, arbitrage can be extended to any commodity of a standard or uniform quality and purchasable in the markets of the great commercial nations. Thus a bale of cotton, a share of Pennsylvania railroad stock, a kilogram of gold, a sterling draft can be freely bought or sold in London, Paris, or New York. For the purpose of the present discussion, the treatment of arbitrage will be confined to transactions in foreign exchange.

As stated above, arbitrage transactions are conducted in several markets in order to derive profit from the prevailing price differences. So far this chapter has considered exchange trading as conducted directly between two markets. However, under certain conditions it may be possible for a trader to obtain greater profit in buying or selling indirectly or arbitrating through one or more other markets. When he uses one other market as intermediary, he is conducting a simple arbitrage transaction, while more than one market is employed in a compound arbitrage transaction.

EXAMPLES OF ARBITRAGE TRANSACTIONS

A simple arbitrage transaction would be operated in this manner: Suppose a trader in New York wishes to buy francs. He notes that the franc in New York is selling for \$.1925 and the pound sterling for \$4.8600, while in London francs are quoted at the rate of 25.25 for one pound sterling. If the trader purchased francs directly with dollars in the New York market, he could buy 25,247 francs for \$4,860. However, it would be cheaper for him to sell dollars for sterling and with it buy francs in the London market. There his \$4,860, now converted into £1000, will command 25,250 francs. By this indirect purchase a profit of three francs is thus effected.

A compound arbitrage is illustrated by the diagram on page 96, which may be explained as follows:

1. The Guaranty Trust Company of New York (A) buys 1,000,000 francs at 6.70 cents from the National City Bank of New York (B).

2. This bank orders its Paris correspondent, the Banque de Paris et des Pays Bas (C), to transfer this sum to the Comptoir Nationale d'Escompte (D) for the account of its correspondent, the Guaranty Trust Company.

3. The Banque de Paris et des Pays Bas accordingly transfers this sum to the Comptoir Nationale.

4. The London Joint City and Midland Bank (E) buys 1,000,000 francs at £46.60 from the London County, Westminster and Paris Bank (F).

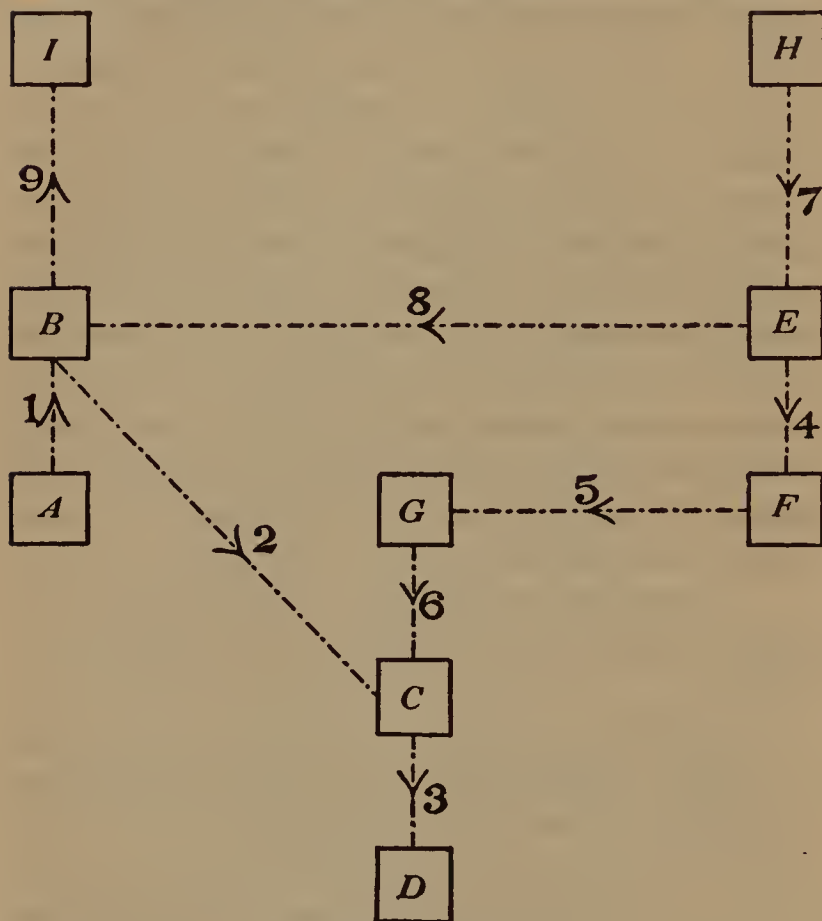


ILLUSTRATION 6

Transaction in Compound Arbitrage

5. This bank orders the Société Générale (G) to pay this sum to the Banque de Paris et des Pays Bas, correspondent of the London Midland Bank.

6. The Société Générale accordingly transfers the amount to the Banque de Paris et des Pays Bas.

7. Barclays Bank of London (H) buys \$67,000 at 4.85 from the Midland Bank.

8. This bank orders its New York correspondent, the National City Bank, to transfer this sum to the Chase National Bank, correspondent of Barclays Bank.

9. The National City Bank accordingly transfers this sum to the Chase Bank.

As a result of the above operations, the three banks, namely, the National City Bank of New York, the Banque de Paris et des Pays Bas, and the Midland Bank, have jointly made a profit of £46/3/6/, appearing on the bank of the London Midland Bank. The bookkeeping entries would read thus:

NATIONAL CITY BANK ACCOUNT (in dollars)

DEBIT		CREDIT	
Pay't to Chase Nat'l Bank.....	\$67,000	Sale francs 1,000,000 @ 6.70.....	\$67,000

BANQUE DE PARIS ET DES PAYS BAS ACCOUNT (in francs)

DEBIT		CREDIT	
Pay't to Comptoir Nat'l d'Escompte for a/c Guaranty Trust Company...	1,000,000	From Société Générale for a/c Midland Bank.....	1,000,000

MIDLAND BANK ACCOUNT (in pound sterling)

DEBIT		CREDIT	
Purchase fcs. 1,000,- 000 @ 46.60.....	21,459 4/0	Sale \$67,000 @ 4.65.	21,505 7/6
Profit.....	46 3/6		
	21,505 7/6		21,505 7/6

From these transactions it is clear that arbitrage brings the foreign exchange markets of the world in closer relationship, and tends to reduce differences in quotations. With the development of cable and wireless communication, arbitrage transactions grew in importance, so that by 1914 discrepancies in exchange rates had been reduced to a narrow margin. With the outbreak of the war, European nations restricted, and in some cases prohibited absolutely, arbitrage transactions. Even at the present time they can be effected only with great difficulty.

ARBITRAGERS

An arbitrage transaction may involve such parties as a debtor or a creditor. A debtor who must meet an obligation in the currency of a foreign country naturally wishes to purchase this exchange in the cheapest market; conversely, a creditor who is paid in foreign money desires to sell such exchange in the best market. The debtor or creditor may possibly seek an opportunity to make the best bargain, not

by direct dealing but through an arbitrage operation. In actual practice, arbitrage in exchange can be conducted only by a banker of unquestioned financial standing abroad and with adequate foreign balances. As mentioned above, pure arbitrage implies the elimination as far as possible of the time factor of speculation, and as the margin of profit on each transaction is relatively small, the element of credit risk must likewise be debarred. Thus arbitrage transactions can be conducted only by the large international banks. Each employs a trader whose task is to note and take advantage of discrepancies in exchange rates. These arbitragers must not alone be close observers of exchange quotations but also careful students of financial and also of political conditions in foreign countries.

TYPES OF EXCHANGE OPERATIONS

In order to illustrate the application of the principles described above, several typical transactions in foreign exchange may be traced. Assume that the American Exporting Company has sold £10,000 worth of cotton to the British Importing Company. After drawing a draft on the British bank designated by the importer, the American firm then sells the bill to its own bank. The trading department records all the facts concerning the deal on a contract form. The American Exporting Company then delivers the draft, and the trading department

“applies” or compares it with the contract in order to verify all conditions, such as amount and rate. The indorsements are carefully examined to make sure that the draft has been properly negotiated, and also the accompanying shipping documents are closely scrutinized in order to ascertain whether or not they are freely transferable. The bank then sends the draft to its London correspondent, which presents it either for payment or acceptance to the payee bank. This institution makes payment immediately in the case of a sight draft, or accepts and pays at maturity in the case of a time bill. In either event the British bank obtains reimbursement from the British Importing Company.

In the above case it has been assumed that the bank has purchased the exchange from one of its own customers, but the majority of bills are bought from non-customers through the mediation of brokers. In that event the broker sends a copy of the contract showing the details of the transaction to the American Exporting Company. Thereupon it gives the draft to its own bank which in turn delivers it to the buyer of the exchange.

The procedure in the sale of foreign exchange for future delivery differs from the above spot transaction, only in that a longer period of time intervenes between the sale of exchange and its delivery. For example, in April the American Exporting

Company sells cotton for shipment in July. It, therefore, sells not spot but future exchange and delivers it, say, three months later.

The above procedure in handling the sale of spot or future exchange is also followed quite similarly in the purchase of exchange. Thus the American Importing Company, which intends to buy drygoods to the value of ten thousand pounds sterling three months from date, may purchase the required exchange from its own bank or through a broker. In the latter case the terms of the purchase are sent to the American concern, which forwards the bank a letter of confirmation giving its assent.

In the above description of possible exchange operations, whether purchases or sales, whether spot or futures, these dealings have been assumed between banks and business houses trading in exchange for their own commercial needs. The same general procedure takes place in transactions made for the purpose of speculation. A slight difference arises in the case of a purchase of future exchange. Let us assume that the speculator buys one thousand pounds sterling at \$4.70 on option for delivery at the end of three months. When his option expires the speculator may either call for delivery of the exchange or ask for an extension of time. If he fails to communicate his wishes to the bank it then has the right to sell the exchange at the prevailing rate.

COUNTRY BANK DRAWING

In presenting the subject of exchange trading, it has been generally assumed that the business man desiring to purchase or sell foreign bills is a customer of a bank which is able to furnish this service directly. For this purpose a bank must conduct a trading department and maintain balances abroad. However, these policies are not followed by the vast majority of American banks, since they have relatively little direct interest in foreign financing. Nevertheless, they are able to supply their customers with complete exchange service through arrangements with their New York City correspondents known as country bank drawings. Under this plan the city correspondent mails or wires to the country banks a daily rate sheet with quotations high enough to allow for any fluctuations which may occur. Thus, a person in Akron, Ohio, may obtain a cable transfer, sight draft, or time bill directly from his local bank, which draws on a foreign financial institution where the city correspondent carries a balance. At the same time the country bank informs its city correspondent of this drawing, and the latter debits the account of the former. Under this system the city bank is giving its country correspondents the right to draw on the former's foreign balances, but does not receive information of such drawings for some time after they have

been made. Hence the city bank does not always know its true position, and without being aware of it may be short on certain exchanges. This risk may be somewhat reduced by limiting correspondents to a certain maximum sum. Notwithstanding this defect, the plan of country bank drawing is necessary in the United States under the present system of independent instead of branch banking.

CHAPTER V

INTERNATIONAL BANKING INSTITUTIONS

CLASSIFICATION OF INTERNATIONAL BANKING INSTITUTIONS

Banking institutions engaged in financing international business transactions may be classified on the following bases:

- (1) Economic function.
- (2) Legal status.
- (3) Operating method.

On the principle of economic function, banks in general may be grouped as either commercial or investment. The former are engaged in granting short-term credit to facilitate the movement of goods; the latter are concerned in furnishing long-term credit to aid production. It must not be thought that a sharp distinction can actually be drawn between these two types of finance, for at times they are both conducted by the same institution and moreover foreign loans are often in a twilight zone as far as classification in respect to their maturity is concerned.

According to legal status, banks are either private or public. Public banks, in the sense of being

operated by public or government capital, are non-existent with the exception of the Riksbank of Sweden and Bank of the Republic of Uruguay. True, the United States Government from public funds created the War Finance Corporation, but it was organized only to meet the financial needs of a temporary emergency situation. Cuban agencies are now conducted by the Federal Reserve Banks of Atlanta and of Boston, and correspondent relations with European central banks were maintained during the war by the Federal Reserve Bank of New York, but even these reserve banks, it must be remembered, are private institutions whose capital stock is owned by the member banks in Reserve System. The Anglo-Czech Bank, operating largely in Austria and Czecho-Slovakia, is supervised by the Bank of England, but it in turn is owned by private shareholders.

Thus it may be said that practically all foreign banks are privately owned. However, the term "private" may be interpreted so as to refer not to the matter of ownership but rather to the subject of incorporation. According to this principle, foreign banking institutions are either private, that is, unincorporated, or public in the sense of being incorporated or chartered. In the United States these charters may be obtained either from the national or the state government. Financing foreign business requires greater resources to-day than in

former years and so in all countries of the world the tendency is to form corporations, as this type of organization is better adapted for the assembling of big units of capital.

Banks may also be classified according to the method of their operation. The essential purpose of a bank is to extend credit. Some accomplish this end by receiving deposits and with these as a basis granting credit. Other banks operate not by the deposit method but in an intermediary capacity between borrowers and lenders. In the first class belongs the commercial bank, which performs essentially the two operations of receiving deposits and granting loans. Thus national banks and trust companies receive deposits and aid in the financing of domestic and foreign business.

The banks which operate on the mediation principle may be further subdivided. One type of intermediary financial institution holds claims on other parties and upon these obligations issues its own. In the field of commercial banking this type is known as an acceptance house. This financial institution illustrates well the theory which considers that the main function of a bank is that of guaranteeing credit. A merchant desires to import goods from a distant country, but there his credit standing is unknown. Acting for him, a London acceptance house with a good reputation abroad will accept drafts up to a certain amount and these acceptances

can then be sold in the open market. In the investment field the financial institution which takes over the obligations of others and sells its own claims is known as an "investment trust." This type is quite general in Europe and Great Britain, but in the United States with very few exceptions it operates only in domestic banking.

Intermediary banks may also act in true middleman capacity in buying the obligations of one set of parties and selling these claims to another group. Thus drafts drawn on accepting banks are sold through dealers to buyers desiring to invest funds over a short period of time. In the field of long-term credit this function is performed by the investment banker who purchases the obligations of governments and corporations and markets these securities among investors.

A third type of financial intermediary is one which does not buy and sell commercial or investment paper, but merely facilitates its transfer and for this service obtains a commission. Short-term paper is thus handled in London by a bill broker, similarly foreign exchange by a foreign exchange broker, and investment paper or securities by a stock broker. These various elements in the foreign financial structure may be summarized as follows:

Classes of Foreign Financial Institutions

OPERATING METHOD		ECONOMIC FUNCTION	
		Commercial	Investment
Deposit		National banks Trust companies	
Inter- mediary	Hold obligations of others Sell own obligations	Acceptance house	Investment trust
	Buy obligations of others Sell these obligations to others	Acceptance dealer	Investment banker
	Brokerage business	Bill broker Foreign exchange broker	Stock broker

OBSTACLES TO THE INTERNATIONALIZATION OF THE AMERICAN BANKING SYSTEM

Even to the present time the American banking system is not truly international in nature. Although the United States from the days of the first colonists has always been interested in foreign trade, the machinery for financing even a minor part of the business was not developed in this country until recent years. This defect in the American banking system can readily be explained. It is

essentially local in nature, consisting of thousands of small institutions interested mainly in granting credit to near-by agriculture or manufacture. This decentralized character has seriously hampered the United States in financing its foreign trade, which requires above all a concentration of national interest in order to meet on equal terms the competition of foreign institutions which have learned the value of co-operation.

Moreover, the credit extended by American banks has been generally of short maturity. Although in farming communities banks have carried in their portfolios agricultural paper of relatively longer tenor, nevertheless most American banks grant credit with an average maturity of about three months. This period is generally too short for the financing of exports and imports which require usually six months or longer. Such extensions have not generally been regarded with favor by American banks accustomed to short-time loans.

Furthermore, American banks in the past have been unable to participate in foreign finance owing to the lack of native personnel capable of handling the business. It undoubtedly is more complex than domestic banking and requires greater technical knowledge. Before 1914 few Americans possessed the necessary training and so Englishmen, Germans, and other foreigners were employed.

The development of international banking in the

United States has passed through the following stages of organization: (1) private banks, (2) foreign departments of banks and trust companies, (3) overseas banks, (4) specialized banks. Although no clear-cut division among these successive steps has existed, nevertheless they indicate in general the leading tendencies in the internationalization of American banking.

PRIVATE BANKERS

Because of the obstacles mentioned above, national banks and trust companies undertook practically no foreign financing, but instead left this business largely to private bankers. These were unincorporated institutions organized as partnerships and affiliated with foreign firms usually bearing the same or a similar name.

DEVELOPMENT OF FOREIGN DEPARTMENTS

Private bankers had an almost undisturbed possession of the field of our international finance until the opening of the twentieth century, when the need for foreign banking service by American institutions became more insistent. Immigration was growing rapidly, and in consequence remittances were flowing increasingly to Europe. Americans were traveling abroad in greater numbers and so tourist funds had to be furnished. As exports of raw materials declined relatively in proportion to manu-

factured goods, the financial technic became more intricate and required more careful handling. In response to these forces, toward the close of the nineteenth century several New York banks opened foreign departments. The first to enter this field of business was the Bank of New York, which in 1893 began to open foreign commercial credits. The Equitable Trust Company, the National City Bank of New York, the Guaranty Trust Company and the National Bank of Commerce in New York soon followed, and in the following decade the Chase National Bank and Bankers Trust Company were added to the list of American banks which offered facilities for foreign trade financing. In the same period foreign departments were also started by a few San Francisco and New Orleans banks to aid in handling the Far Western and Southern export business.

It was not until after 1914 that American banking in any sense of the term became internationalized. Although the war put an end for a time to the inward movement of immigrants and the outward flow of tourists, thereby reducing a certain amount of the foreign business of American banks, on the other hand the conflict created an unprecedented volume of transactions in goods and securities. The burden of financing this business was too heavy even for the experienced European banks and so had to be transferred to American institutions.

Fortunately the structure of the American banking system just a few months before the outbreak of the war had been reorganized and modernized by the passage of the Federal Reserve Act. This legislation, by giving national banks wider powers such as accepting drafts, has made it possible for American banks to undertake the onerous tasks which have arisen since 1914.

In response to the needs of the Allies which became greater as one year of war followed another, a growing number of banks developed special foreign departments. Banks with foreign departments in order to handle their own business and that of domestic correspondents have either opened branches abroad or selected foreign banks as their agents.

ORGANIZATION OF A FOREIGN DEPARTMENT

A consideration of the problems of the relation between institutions with foreign departments and interior banks, the choice between foreign branches or correspondents and the technical operations of foreign banking will be deferred to later chapters.

At this point a brief reference should be made to the changing relationship which has taken place between the foreign department and the rest of the bank. At first the foreign department was simply a new unit added to the organization for the purpose of rendering specialized service to a small range of

customers and ranked about the same in importance as the bond or trust department. The foreign department was usually operated not as an integral part of the bank but rather as a separate entity, for it was regarded as engaging in new and hazardous operations from which the rest of the bank should keep itself as free as possible. As a result, the foreign department developed a number of subdivisions for accounting, credit rating, and other operations separate entirely from the bank. Thus the foreign department became actually a bank within a bank in some institutions. This plan of organization has in some cases been carried to such an extent that the foreign department pays rent for the floor space which it occupies and carries separate entries for its profit and loss. There is now considerable reaction against this system and in the more progressive institutions the foreign department has been completely merged. As a result, the distinction between the domestic and foreign divisions is entirely lost, and the bank thereby becomes an internationalized institution.

The services rendered by a foreign division are well described in a circular issued by the Guaranty Trust Company of New York and reading in part as follows:

CURRENT DEPOSITS AND SPECIAL ACCOUNTS

The Foreign Department opens checking accounts in dollars or in foreign moneys in New York, paying interest on balances of \$1,000 or more; in London, on balances of £250 or more, and in Paris on balances of Fcs. 5,000 or more. On deposits not to be withdrawn within a definite period, a higher rate of interest can generally be allowed than on checking accounts.

PURCHASE AND SALE OF EXCHANGE

It buys checks, money orders, sight and time bills of exchange, and documentary drafts drawn on any foreign place.

It sells demand and time drafts in foreign currencies payable in the principal cities of the world. It effects transfers of funds and payments by mail or by cable to any part of the world.

INSURANCE AGAINST FOREIGN EXCHANGE LOSSES

It secures in advance, whenever practicable, definite future rates at which time drafts will be paid, thus insuring its customers against possible loss of foreign exchange on transactions for future shipment or delivery.

DIRECT DRAFTS ON FOREIGN BANKS

It provides American banks with facilities for drawing drafts direct on its foreign offices and foreign correspondents, at the current rates of exchange.

IMPORT AND EXPORT CREDITS AND PAYMENTS

It finances shipments of merchandise from any of the principal commercial centers of the world by establishing letters of credit in favor of the foreign shippers. It also effects payments to American manufacturers and others under export letters of credit.

CIRCULAR LETTERS OF CREDIT AND
TRAVELERS' CHECKS

It issues circular letters of credit in dollars, pounds sterling, and francs, available in any part of the world.

It issues a new form of travelers' check in denominations of \$20, \$50, and \$100, equally suitable for domestic or overseas travel, and payable in all parts of the world.

FOREIGN MONEYS BOUGHT AND SOLD

It buys and sells foreign gold and silver coin, foreign bank notes, and other legal tender.

DISCOUNTS OF COMMERCIAL PAPER

It discounts trade acceptances and domestic and foreign bills of exchange, drawn and indorsed or accepted by satisfactory banking institutions and commercial firms and corporations. It will also purchase such acceptances for the accounts of its customers.

At first glance it would seem that these activities are different from those of domestic banking, but a closer examination will reveal quite a similarity in principle. The buying and the selling of exchange, as explained in Chapter III, are simply dealings in foreign bank balances and so are directly related to the creation and reduction of deposits. The operation of letters of credit which authorize the making of drafts against a bank have much in common with the system of drawing checks against a deposit account with a bank. The handling of foreign collections follows the same general principles which

apply to collecting domestic items. Likewise granting loans on collateral or discounting commercial paper are both handled in about the same manner in the foreign as in the domestic division. A credit department is needed in the foreign division, but its management is so much like that of the domestic credit department that the two are frequently combined. In addition, the foreign department may also include a number of external service departments for customers, such as a foreign trade department to furnish information on marketing or financing their exports.

An internal view of a foreign department may be obtained from a detailed and careful description of the sections or "divisions" of the foreign department of the Equitable Trust Company as given below.¹

PAYING TELLERS

Division 1

Here all payments ordered by cable or mail, by our foreign correspondents, are made, and transfers on our books effected. Where we have both foreign accounts on our books, and instructions are given us by one bank to debit them and credit the account of another bank, we call this an internal transfer. For example, the Deutsche Bank, Berlin, might instruct us to debit their account and credit the account of Credito Italiano, Milan. All transfers of this character are handled in Division 1. This division also pays all drafts drawn on us by our foreign correspondents.

¹ Article by Mr. H. D. Nagel in the *Equitable Envoy*, Vol. 2, No. 8 (Feb. 1923).

FOREIGN ARRANGEMENTS

Division 2

Division 2 handles the Foreign Department's new business and credit work. All credit files regarding clients who carry accounts with us or files regarding our own accounts carried abroad are kept here. Special instructions received from our depositors relative to handling their business are also kept in this Division and this special information regarding the handling of accounts is given by the Foreign Arrangements Division to other divisions of the Foreign Department. Division 2 also handles the purchase and sale of South American exchange.

IMPORT LETTERS OF CREDIT

Division 3

In this division, we finance the shipments of merchandise from foreign countries to the United States. All information regarding commodities shipped from other countries is available here together with data regarding the necessary legal requirements to be met in order to comply with the laws of each country in making shipments.

TRAVELERS' LETTERS OF CREDIT

Division 4

Division 4 issues our Travelers' Letters of Credit, both in dollars and foreign currencies. This division also sells foreign currency and Travelers' Checks. As a part of its travel service, it cares for the needs of travelers, as in the purchase of steamship and railway tickets and the dissemination of information relative to passports, etc. The Customers' Room where people holding Letters of Credit issued by our foreign correspondents are received is a part of this division. In addition to this work, Division 4 has charge of direct drawing or settlements made to us by inland banks who draw on our foreign correspondents for our account. Drawings by our foreign correspondents on our inland correspondents are also handled here.

FOREIGN BOOKKEEPERS

*Division 5**Nostro Foreign Accounts and
General Bookkeeping*

This division keeps all entries and records regarding our foreign accounts carried abroad. The general books of the Foreign Department are also kept in this division. In these general books are the records of the assets and liabilities of the foreign department.

EXCHANGE RECEIVED

Division 6

The remittance letters, forwarding checks, drafts, and bills of exchange drawn on foreign countries, whether in foreign currencies or United States dollars, are recorded in this division. This division also handles coupons payable abroad, for example: coupons of the United Kingdom of Gt. Britain and Ireland 4% Funding Loan of 1919, payable in England, are examined here and sent to our London Office for collection. London then credits our sterling account advising us and we in turn reimburse our client.

CABLES

Division 7

The Cable, or Division 7, cares for all incoming and outgoing telegrams, cables, and radiograms. All purchases and sales of cable transfers are recorded here and domestic wire payments are made. A domestic wire payment is handled as follows: A customer will instruct us to pay Mr. John Doe in St. Louis a certain sum of money — we wire our correspondent bank to effect payment.

Division 7 maintains its own bookkeeping department to record the cost of incoming and outgoing messages. To enable

us to render the most efficient service possible, we use our own telegraphers who have pony wires direct to the different cable companies. Our telegraphers are also in charge of the direct wire connections which link our domestic offices to the home office. To handle properly the incoming messages, so that they will be in the possession of the clerks in the Foreign Department promptly each morning it is necessary to maintain a night force. This force takes up its duties at 1:00 A.M. and works until 9:00 A.M. The day force arrives at 9:00 A.M. and works through until 5:30 P.M. Another force arrives at 12:00 o'clock noon and works until it has finished the daily work; usually about 7:30 P.M. To properly supervise this work, we have four supervisors in our Cable Department.

LIQUIDATIONS

Division 8

Remittances received from countries outside of the United States in payment of our collections are settled here. For example, when our foreign correspondents advise us of the collection of our remittances sent to them, these advices are handled by this division, who properly record the transactions. This division also makes loans on documentary bills drawn in United States dollars, showing shipments of commodities outside of the United States, *i. e.*, the documents generally consist of bill of lading, insurance certificate, and commercial invoice endorsed to us, which gives us possession of the merchandise while the bill is in process of collection. We make loans on these documentary bills to the customers shipping the goods in varying percentages up to 80 per cent.

RECEIVING TELLERS

Division 9

Receives all monies for credit of accounts in Foreign Department and for payment of cables and wireless transfers sold or for payment of foreign drafts sold.

TRADING

Division 10

This division sells clean drafts and cable transfers. It buys clean and documentary drafts, sight or time, and cable transfers.

For example: a clean draft is really a check on some foreign bank, purchased by a customer for remittance abroad. This transaction is similar to that performed by a person drawing a check against his bank account.

DOLLAR BOOKKEEPERS

*Division 11**Vostro Accounts*

Division 11 — the Dollar Bookkeepers handle the bookkeeping of the foreign banks, firms, corporations, and individuals who carry accounts with us. Boston ledgers are used and Elliott-Fisher bookkeeping machines.

EXCHANGE SOLD

Division 12

All foreign drafts sold, whether in foreign currencies or United States dollars, are drawn here, and necessary advices sent. This division also makes payments in foreign countries. For example, a mercantile firm in New York might instruct us to pay a firm in Paris for the purchase of commodities.

INCOMING COLLECTIONS

Division 13

This division handles all documentary remittances, sight or time, on New York City or other parts of United States, whether in United States dollars or foreign currencies, received from our foreign depositors for their accounts. It also handles consignments received for customers' accounts. Commodities are sent to us by our foreign correspondents for sale to merchants in this

country. We warehouse the goods and endeavor to sell the goods according to the wishes of our foreign clients.

EXPORT LETTERS OF CREDIT

Division 15

Export credits opened by our foreign depositors for shipments of commodities from the United States are handled by this division. It also handles shipments from one foreign country to another foreign country.

LOANS

Division 16

Division 16 makes loans on commodities stored in the United States for ultimate shipment abroad, generally against warehouse receipts. It also handles consignments sent abroad by our domestic clients.

TRANSLATION

Division 17

Translates letters in foreign languages into English and vice versa.

ACCEPTANCES AND DISCOUNTS

Division 18

The Acceptance and Discount Division accepts drafts drawn under our Import and Export Letters of Credit. Accepts drafts for customers' accounts when commodities are sent abroad on consignment. Accepts drafts for our foreign correspondents to create dollar exchange. Handles the purchasing and selling of acceptances, drawn on banks and institutions, payable in the United States.

MAIL TELLERS

Division 19

Collects all clean sight items, checks, and drafts, drawn on United States.

SECURITIES

Division 20

This division is in charge of the safe-keeping of securities, comprising securities sent to us for sale by our foreign clients, and securities placed with the foreign department as collateral. This division also keeps a record of all guarantees issued.

DRAFT ADVICE

Division 21

As nearly all drafts drawn on us by our foreign depositors are drawn in original and duplicate, we keep a record of each draft drawn. This division records all drafts drawn and checks all payments. If the original is paid, the duplicate, if presented, is not paid, and in case the duplicate is presented for payment first, the original is not paid later.

CIPHER KEY

Division 23

All cable or wireless messages received or dispatched, involving payment or action, must have an authentic numeral or certain means to ascertain the genuineness of same. The work of this Division is to see that all depositors or clients of the bank have our private key to authenticate their messages and that the proper use is made of this code. Division 23 also prepares private codes for use between our foreign correspondents and ourselves.

PROOF CLERK

Division 24

The block system is used by all divisions of the Foreign Department and they turn in their debits and credits together with run-up to the Proof Clerk. The Proof Clerk sees that the various departments of the bank are debited or credited accordingly.

STENOGRAPHIC

Division 25

Owing to the technical detail involved in foreign transactions, most divisions have certain stenographers assigned to them permanently, but they may call upon the head stenographer for additional help, in emergencies. All stenographers in the Foreign Department are under the direction of the head stenographer.

OVERSEAS BANKS

The growth of foreign trade has led not alone to the opening of foreign departments in domestic banks, but also to the creating of institutions devoted exclusively to financing foreign trade. Such overseas banks were organized by the British over half a century ago, but the first American institution of this kind was the International Banking Corporation founded in 1902. The bank operates under a Connecticut charter which enumerates a number of powers and besides confers the right "to engage in any lawful business whatsoever." The bank has its home office in New York City, but through foreign branches has extended its activities to all parts of the world. However, the usual policy of such overseas banks is to limit their operations to a certain area, as for example the Asia Banking Corporation whose business was confined to the Orient.

In order to encourage the further growth of such special banking corporations, successive amendments were made to Section 25 of the Federal Reserve Act.

In 1916 national banks with a capital and surplus of over one million dollars were given permission to invest up to ten per cent in the stock of corporations engaged in foreign banking and supervised by the Federal Reserve Board. This provision applied only to large banks, and in order to extend it to smaller institutions, the Federal Reserve Act was further amended by the McLean-Platt Act which allowed any national bank regardless of capitalization to subscribe to a limit of five per cent of its capital and surplus in the stock of a foreign banking corporation.

A few national banks availed themselves of these powers, but they were forced to participate in overseas banking institutions chartered under the state law, since no provision for their organization had been made under federal law. This omission was finally overcome in 1919 when Congress passed the so-called "Edge Act." This piece of legislation is not a separate statute but merely a further amendment to section 25 of the Federal Reserve Act. Banking associations organized under this act must have a minimum capitalization of two million dollars. In order to restrict foreign ownership and control of these corporations, a majority of the capital stock must be held by United States citizens and they alone can serve on the board of directors.

The Edge Act provides for two classes of institutions. One type is to extend investment credit, by

taking long-term paper such as bonds and mortgages and against these, as underlying collateral, issuing its own debentures which in turn are to be sold to American investors. In contrast to these "investment trusts," the Edge Act also provides for the establishing of institutions to grant short-term or commercial credit. These foreign banking corporations are to possess about the same powers as exercised by the foreign departments of domestic banks, with the exception that the former are not to receive deposits within the United States save those incidental to foreign business. No domestic banking powers are permitted, although of course an Edge corporation may establish agencies within the United States, and in such cases will necessarily perform domestic operations incidental to foreign business. Edge corporations are permitted to accept drafts up to ten times their capital and surplus, while national banks can assume such liabilities only to an amount not exceeding their capital and surplus.¹ Because of their extraordinary acceptance privilege, Edge corporations are often described as simply acceptance houses, but it must be remembered that they are empowered to perform practically all the operations of commercial banking, such as buying or selling foreign exchange, handling collections, issuing letters of credit and granting loans.

¹ This does not include dollar exchange, see p. 389.

SPECIALIZED BANKING INSTITUTIONS

In recent years several attempts have been made to establish acceptance houses in New York. These institutions finance foreign trade by accepting drafts based on the shipment of goods.

Acceptances created either by banks with foreign departments, overseas banks, or acceptance houses, are bought and sold through "dealers." They are usually organized as partnerships but the larger ones, such as the Discount Corporation of New York and the National City Company, are chartered institutions.

INTERRELATED ORGANIZATION AMONG BANKS
FINANCING FOREIGN TRADE

The development of foreign trade requires close co-operation among the business interests of a country in order successfully to meet the competition of other nations. This principle has been recognized even in the United States, where there has always been determined opposition against any movement toward combination, but the policy has been more closely followed by the large commercial countries, such as Great Britain and Germany, where the movement toward banking concentration has long been in progress.

The financing of foreign trade has in most countries been directed by a small group of banks. Such

a policy would prove impossible in the United States where the banking system is composed of many thousand independent banks. Nevertheless the principle of co-operation among banks has to a certain extent been applied in the financing of foreign trade. Although the plans for overseas banks, discount companies and acceptance houses are usually initiated by the larger New York institutions, at the same time they invite their interior correspondents to participate in such ventures. For example, the Asia Banking Corporation was organized by the Guaranty Trust Company of New York, and later stock was sold to the Continental and Commercial banks of Chicago, the Guardian Savings and Trust Company of Cleveland, and other inland banks. Again, the Foreign Credit Corporation, an acceptance house, was owned jointly by the Central Union Trust Company of New York and out-of-town banks such as the National Shawmut of Boston and the Philadelphia National. A New York institution will sometimes join with banks located in one area of the United States and interested in trade relations with only a particular part of the world. Thus the Equitable Trust Company of New York founded the Equitable Eastern Banking Corporation as a common undertaking with several Pacific banks, including the Mercantile Trust Company of San Francisco and the North Western National Bank of Portland. The initiative does not

always emanate from New York City, but may also be taken by a number of banks located in the same territory and concerned in the financing of the same kind of products. For example, The Federal International Banking Corporation was organized entirely by Southern banks which desired more adequate credit facilities for the exportation of cotton, tobacco, and lumber. Far western interests have organized the Federal Pacific Banking Corporation as an Edge bank to finance long- and short-term operations with the Orient.

Several international credit institutions have been organized, not by one large New York bank supported by its interior correspondents, but by several major New York institutions acting in conjunction with one another.

The distribution of the stock in foreign subsidiary institutions at times varies considerably. It is closely held as in the case of the International Banking Corporation, seven eighths of whose stock is owned by the National City Bank of New York. Such a policy is the exception and not the rule. Organizers of overseas banks aim to distribute the stock widely, as illustrated by the American Foreign Banking Corporation, which is owned by thirty-six banks located in thirty-three different cities. The Federal International Banking Corporation counts as its stockholders about a thousand banks in the South, a policy of stock distribution which is well

adapted to the American system of independent banking. The stock of foreign financing institutions is mainly held by banks, and is rarely offered to the public. Several small enterprises placed their shares on the market for public subscription, but in general their careers have been short-lived.

Several international banks have been formed as the result of alliances between American and foreign financial interests. The French-American Banking Corporation is owned half by the Comptoir National d'Escompte de Paris and half equally by the National Bank of Commerce in New York and the First National Bank of Boston. On the other hand, the stock of the International Acceptance Bank is widely distributed among a large number of European and American banks.

It is quite a natural policy for stockholding banks to be represented on the directorate and on the staff of the auxiliary institutions. Thus the directors of the Discount Corporation of New York include the presidents of five leading New York banks. In the case of other overseas banks, the president, vice-president, or secretary concurrently holds office in the parent bank.

REASONS FOR THE ESTABLISHMENT OF FOREIGN BANKING INSTITUTIONS

In considering the various classes and the inter-relations of foreign banking institutions, some of the

reasons for their establishment have been indicated. Private banking firms in New York, Boston, and Philadelphia were founded by foreign interests in order to facilitate their business relations with the United States. Naturally, profit has been the underlying motive in the opening of foreign departments by American banks, but they have also been actuated by the need of giving a complete banking service, foreign as well as domestic, to their customers who might otherwise be attracted by more progressive competitors.

Separate overseas banking institutions have been organized from a wide variety of motives. One aim in their establishment has been the desire on the part of the parent banks to relieve themselves of the risks which are more serious in the financing of foreign than of domestic business. As explained in Chapter II, the financing of foreign trade necessitates the granting of long-term loans which carry the danger of illiquidity to banks having demand liabilities in the form of current deposits. Moreover, the difficulties in judging credit risks and the hazards arising out of exchange fluctuations have led some banks to create rather special institutions than to perform such uncertain operations in foreign departments of their own. Overseas banks have at times been organized in order to exercise powers which could not very well be assumed by the parent institutions. Since the Civil War the national

government, by a confiscatory tax, has made it practically impossible for state banks to issue their notes for circulation. Nevertheless, in undeveloped countries such as China, it is essential for a bank to extend credit by issuing notes which pass freely in the community as media of exchange rather than by creating deposits, since the use of checks is unknown to the natives. Because of these conditions, several overseas banks have been permitted under their state charters to issue their notes for circulation in foreign countries without paying the federal tax.

While the exercise of such powers can in part be justified, the same cannot be said of overseas banks in foreign lands assuming policies which domestic institutions would not generally be inclined to follow within the United States. Some institutions acted not alone as banks but also as merchandise houses and thus carried not only credit but also commercial risks. These banks often found themselves in the inconsistent situation of granting credit to the very dealers who were their competitors.

REVERSAL OF FOREIGN BANKING POLICY

Prompted by the several motives described above, a number of American banks opened foreign departments and organized special foreign credit institutions, so that by the close of 1920, New York had developed both the machinery and the personnel

necessary for the establishing of a world's center for foreign exchange and international credits.

The year 1921 witnessed a sharp reaction from the previous policy of expansion. The foreign departments of banks were considerably contracted and in some instances entirely closed, and the employes transferred to other departments or discharged. More than a dozen branches and agencies of American banks were discontinued during the year. Of even greater significance than the contraction of foreign departments and the closing of branches was the withdrawal, partial or complete, of most of the specialized foreign trade banks.

One of the most important was the Mercantile Bank of the Americas, organized in 1915 by several New York banking institutions. The Mercantile Bank was authorized to conduct a general banking business with the right of establishing branches abroad and of investing in the stock of banks and business corporations operating in foreign countries. In accordance with these powers the bank created branches in several European cities and founded a separate bank in each of the more important countries of Central and South America. These affiliated institutions in turn organized branches within the several countries. In addition, the Mercantile Bank also secured the controlling stock of several corporations engaged in buying and selling merchandise. The reversal in the trade balance between the United

States and South America, the decline in the price of such commodities as coffee, sugar, and cocoa, and the fluctuations of the foreign exchanges all rendered it difficult for the customers of the Mercantile Bank to liquidate the loans which they had received. As a result of these frozen credits, the bank was forced to obtain aid from the stockholding institutions, which subscribed to additional capital and extended acceptance credits. As a result of these losses the Mercantile Bank closed several of its branches in Europe and disposed of its stock in several of its affiliated banks in South America. In 1922 the bank was reconstituted as the Bank of Central and South America.

The decline in foreign trade was also the cause of the liquidation of the Foreign Credit Corporation started in 1919 by several New York banks. This institution was formed for the purpose of creating acceptances covering exports and imports and in this field proved financially successful. Its last statement showed fair profits and liquid assets. However, the stockholding banks wished to release cash from their holdings in order to apply these funds to other purposes, and in consequence the Foreign Credit Corporation was dissolved. Its business was transferred largely to the foreign departments of the parent banks.

In 1918, several banks formed the Foreign Trade Banking Corporation for the purpose of discount-

ing acceptances. This institution differed from the Foreign Credit Corporation, which was rather an acceptance house and not a discount company. The Foreign Trade Banking Corporation was also voluntarily dissolved by the stockholders and the reason given was the unsettled exchange conditions prevailing in 1921.

Some of the overseas banks were organized not as permanent institutions but as temporary machinery to meet the emergencies of war and post-war finance. The Export Banking Corporation was formed in 1920 for the specific purpose of financing the exportation of cotton to Czecho-Slovakian spinning interests who were encountering difficulties in obtaining the necessary credit accommodation from regular banking channels.

FOREIGN FINANCE CORPORATION

The most spectacular undertaking was the attempted formation of the so-called "Hundred Million Dollar Foreign Trade-Finance Corporation." This organization was approved at the annual meeting of the American Bankers Association at Washington in October, 1920, and was endorsed the following December at a special session in Chicago. The corporation was to be organized under the Edge Act and was to be formed as a debenture and not as an acceptance institution. The stock was to be issued at 105, thus providing

\$100,000,000 of capital and \$5,000,000 surplus. An active campaign for stock subscriptions was begun early in 1921, and widespread publicity was given the undertaking which received the support of practically every organization interested in foreign trade. However, the drive for selling the stock did not meet with success and by the middle of 1921 there was a strong tendency on the part of some of the promoters to withdraw from the undertaking. It drifted along until the beginning of 1922 when the enterprise was formally abandoned.

The failure of the Foreign Trade Corporation may be attributed to various factors. The enterprise was launched at a time when the investment power of the United States was at a low ebb after the heavy drain of war financing. In 1919 the investment market was absorbing with difficulty even first-class securities such as the notes of the British Government and the bonds of even standard American railroads. In a market so exhausted, it was well-nigh impossible to obtain funds for a new and untried venture. Although the Corporation was originally planned as a debenture institution, the purpose was later broadened, for a prospectus issued in January, 1921, stated that: "An Edge Act Corporation may, under the law, extend long- and short-term credits, invest in securities, purchase bills of exchange, engage in foreign banking and in any lawful way aid in financing foreign trade." Although the

Federal Reserve Board, in its regulation on the organization of Edge Law Banks, had prohibited the joining of acceptance and debenture business by one corporation, this was not a prohibition in the Federal Reserve Act but merely a Board ruling which could easily be changed. In fact, the certificate of organization issued by the Board to the Corporation stated that it "was incorporated for the purpose of engaging in the business of international or foreign banking or other international or foreign operations." By implication the acceptance power was thus granted. The new corporation was, therefore, regarded as a possible competitor by some banks with foreign departments of their own and these withheld support. The main reason for abandoning the plan for a super-foreign bank was the growing economic confusion in Europe, and the increasing difficulty of conducting profitable business under such conditions.

PRESENT STATUS OF SPECIAL OVERSEAS BANKS

The existing overseas banking institutions formed by American interests, with the date and place of organization, are given on next page.

NAME OF BANK	PLACE OF ORGANIZATION	DATE OF ORGANIZATION
American International Banking Corporation.....	New York	1917
American Foreign Banking Corporation.....	New York	1917
Bank of Central and South America ¹	New York	1922
Bankers Union of Foreign Commerce and Finance....	Boston	1920
Discount Corporation of New York ²	New York	1918
Equitable Eastern Banking Corporation.....	New York	1921
Federal Pacific Banking Corporation.....	San Francisco	1922
Federal International Banking Corporation.....	New Orleans	1921
First Federal Foreign Banking Association.....	New York	1920
First National Corporation...	Boston	1918
Foreign and Domestic Acceptance Corporation.....	Boston	1921
Foreign Bond and Share Corporation.....	New York	1919
Foreign Commerce Corporation of America.....	New York	1920
Foreign Finance Corporation	New York	1919
Foreign Trade Banking Corporation.....	New York	1918
French-American Banking Corporation.....	New York	1919
International Acceptance Bank	New York	1921
International Banking Corporation ³	New York	1902
Overseas Securities Corporation.....	New York	1920
Shawmut Corporation.....	Boston	1919
Warrant Export and Discount Corporation.....	Birmingham, Ala.	1921

¹ Formerly the Mercantile Bank of the Americas.² Deals in acceptances. ³ Includes Asia Banking Corporation.

INTERNATIONAL BANKING INSTITUTIONS ABROAD
BEFORE THE WAR

Before 1914 the banking systems of even the great commercial nations of the world were still purely national in character. The movement for banking concentration had developed in practically all countries, but even these consolidated organizations were primarily interested in financing local business. The German banks, and to some extent the French banks, had developed international operations on a large scale. Until the outbreak of the war, British banks with few exceptions operated no foreign departments but preferred to turn over such business to other institutions especially interested in this field of enterprise.

In every country international finance, both commercial and investment, was largely in the hands of private banking houses with affiliations in all the important money centers. Notable among them were Speyer of London, Rothchild of Paris, Warburg of Hamburg, and Hope of Amsterdam. In every commercial country acceptance houses and discount houses had developed to a high degree of efficiency. Besides, overseas banking corporations had long been organized for the exploitation of certain areas. This type of banking institution had been especially well developed by British interests. The Royal Bank of Canada, the Chartered Bank of India, the

Hongkong and Shanghai Banking Corporation, the Standard Bank of South Africa, even before 1914 were powerful factors in meeting the needs of colonial finance. Although some of these institutions were chartered under colonial law and all were independent of the big British joint stock banks, nevertheless their operation was distinctly along British lines. Special overseas institutions, such as the London and Brazilian, and the London and River Plate Banks, were also organized to operate in non-British territory. On the other hand, the German overseas institutions were both controlled and operated by the "Great" banks. Thus the Brazilianische Bank für Deutschland was controlled by the Disconto-Gesellschaft, and the Deutsch Süd-amerikanische Bank was owned by the Dresdner Bank.

In some cases the big banks joined in the formation of common subsidiary companies known as "Tochtergesellschaften," as for example the Deutsch Asiatische Bank and the Banca Commerciale Italiana which was owned by the Deutsche, Disconto-Gesellschaft, and the Dresdner Banks. This intimate relationship was also maintained by the Belgian bankers, as illustrated in the case of the Société Générale de Belgique, which controlled the Banque Belge pour l'Étranger. Before the war the French had developed practically no specialized banking organization for financing their foreign trade.

CHANGES SINCE THE WAR

The war changed completely the nature of the international banking organization in Great Britain and on the Continent. The big banks in every country took a deeper interest in foreign finance, and in a way it may be said that these banking systems thus became internationalized while at the same time, international finance became nationalized. The British joint stock banks opened foreign departments, entered the foreign exchange markets, and in some cases through subsidiaries established branches abroad or acquired interest in Colonial banks, as for example the assumption of control in the Bank of British West Africa by the London County and Westminster or the purchase of the Anglo-Egyptian Bank by Barclays. The war for a time restricted the activities of the French and Belgian banks, but after the Armistice they greatly expanded their overseas activities. Banks in neutral countries also participated in foreign trade finance on a greater scale than ever after 1914. The entrance of these incorporated banks into the field of foreign banking has tended to reduce the importance of the private houses. As a result they have been forced to abandon much of their trade financing and instead have increased their operations in investment banking. The discount houses have also felt the competition of the big banks and have found it un-

profitable to confine their activities only to the discounting of bills. In consequence they have extended their operations to the entire field of commercial banking, including the receiving of deposits.

These changes have in part been wrought by the needs of reconstruction finance and by the efforts to regain foreign markets lost during the war. The war has intensified the nationalistic movement in every sphere of activity and this tendency has also influenced the organization of international banking. In every country there has been a strong demand for developing an inclusive banking system, capable of furnishing credit for financing the overseas trade of the country, and so freeing it from any dependence upon alien credit institutions. This movement has been especially pronounced in England, which since the war has sought to realize the ideal of an all-British banking system.

NEW OVERSEAS BANKS

Since the close of the war, a number of specialized banks have been organized by several countries, to meet the peculiar credit needs of the present unsettled condition in international trade. This movement parallels the similar tendency in American banking organization as described above. Consideration of this policy as followed outside of the United States will be confined largely to Great Britain, which has undertaken the most interesting

experiments along these lines. Foreign trade is essential for the very existence of Great Britain, and so every effort had to be made to revive commercial relations severed by four years of conflict. In fact, while the war was still in progress plans were laid to anticipate the new conditions which would probably exist with the end of hostilities. Accordingly, a number of overseas banks were organized to aid British commercial interests in particular areas.

Of this group the most important, and at the same time the most interesting from the American viewpoint, are the British Trade Corporation and the British Overseas Bank.

BRITISH TRADE CORPORATION

The British Trade Corporation received a royal charter in 1917 for the purpose of supplying "the best means of meeting the needs of British firms after the war." For the advancement of national interests a portion of the stock was taken by several of the big joint stock banks, although they were at the same time operating their own foreign departments and even foreign banks and branches. The Trade Corporation immediately founded subsidiary companies such as the Levant Company, or purchased an interest in existing concerns such as the Portuguese Trade Corporation.

The experience of the British Trade Corporation has not been fortunate. The reason for its ill success

has been the disturbed political situation in the territories which it endeavored to penetrate. The collapse of Greek influence in the Near East was a serious blow to British interests in general and directly affected the Trade Corporation which had opened several branches in the disturbed area. As a result, the investment in the Levant Company had to be written off as an entire loss, while a similar policy had to be followed in part with respect to several other subsidiaries which found themselves in difficulty.

Another cause of the difficulty of the Corporation was the ill-starred attempt to combine merchandising and banking. With the collapse of commodity prices in 1920, the Corporation had vast stores of unsalable goods on its hands. As a result, in 1922 the sum of £264,000 was written off as loss incurred by the depreciation of the stock held in subsidiary companies, and an additional £359,000 was deducted to cover bad and doubtful commercial accounts.

Notwithstanding these losses, the credit of the company is still unimpaired owing to the prominence of its board of directors who, undaunted by past reverses, are planning operations in new but less hazardous fields.

BRITISH OVERSEAS BANK

Although the British Trade Corporation and the British Overseas Bank are sometimes mistaken for

each other, they are entirely separate organizations, differing both in organization and operation. While the big joint stock banks own a small interest in the former, the latter is controlled through an issue of special stock by a group of eight holding banks. These consist of two classes: colonial banks, such as the Dominion Bank (Canada), and British private banks, as Glyn, Mills, Currie & Company and Williams Deacon Bank. The latter banks, representing Manchester, Liverpool, and other interests outside of London, have joined forces in forming an organization which will give their customers a better foreign banking service than if each developed a separate foreign department. The Overseas Bank may therefore be regarded as the joint foreign department of the supporting banks, which in this way are better able to compete with the big London joint stock banks in offering foreign credit facilities to British merchants.

The Overseas Bank operates under a charter with broad powers, even to the extent of underwriting security issues, but the directors have in these disturbed times wisely chosen to follow a conservative policy. The bank has confined its activities to commercial banking and has preferred to operate through foreign correspondents rather than branches or affiliated companies, except in Poland, where a banking house was taken over. While substantial profits have not been gained, at the same time no

crushing losses have been sustained, and so the Overseas Bank has every prospect of extensive future usefulness.

Another motive which has prompted some of the constituent banks to finance the international trade of their customers through an outside organization rather than an internal department has been their unwillingness to carry directly both foreign and domestic commitments. It is quite a commonly expressed thought that purely local business interests should not be impaired by being commingled with foreign operations, which are considered as more hazardous.

The more important British overseas banks, including those established before and after 1914, may be listed as follows: ¹

Organized under the English companies acts or royal charter (head office, London) and operating primarily in the dominions:

	TOTAL ASSETS
African banks:	
Anglo-Egyptian.....	£14,090,000
Bank of British West Africa.....	12,295,000
Standard Bank of South Africa.....	70,649,000
Australian banks:	
Bank of Australasia.....	37,914,000
English, Scottish, and Australian Bank.....	30,785,000
National Bank of New Zealand (Ltd.).....	14,175,000
Union Bank of Australia (Ltd.).....	40,347,000
Canadian bank:	
Colonial Bank.....	11,458,000

¹ Robinson, L. R. *Foreign Credit Facilities in the United Kingdom*, Commerce Reports, No. 99, pp. 41-43.

Indian banks:

Chartered Bank of India, Australia, and China.	61,768,000
Eastern Bank.	9,712,000
Mercantile Bank of India.	16,429,000
National Bank of India (Ltd.)	42,418,000
Grand total.	£362,041,000

Organized under Dominion acts or charters and maintaining offices in London:

African banks:

TOTAL ASSETS

National Bank of Egypt.	£20,424,000
National Bank of South Africa.	61,506,000

Australian banks:

Australian Bank of Commerce.	13,270,000
Bank of Adelaide.	8,232,000
Bank of New South Wales.	71,662,000
Bank of Queensland.	3,947,000
Bank of New Zealand.	43,330,000
Bank of Victoria.	14,055,000
Commonwealth Bank of Australia.	86,609,000
Commercial Bank of Australia.	20,571,000
Commercial Banking Co. of Sydney.	38,903,000
National Bank of Australasia.	33,195,000
Queensland National Bank.	11,551,000
Royal Bank of Australia.	6,585,000

Canadian banks:

Bank of Montreal.	130,774,000
Bank of Nova Scotia.	45,061,000
Canadian Bank of Commerce.	87,974,000
Dominion Bank.	26,267,000
Royal Bank of Canada.	94,180,000
Union Bank of Canada.	30,525,000

Indian banks:

Alliance Bank of Simla.	¹ 13,177,000
Imperial Bank of India.	¹ 60,502,000
Tata Industrial Bank.	¹ 8,899,000
Grand total.	£931,198,000

Organized under the English companies' acts or royal charter (head office, London) and operating primarily in certain foreign areas:

¹ Converted at 1s. 4d. to the rupee.

	TOTAL ASSETS
Anglo-South American Bank.	£73,435,000
Bank of Rumania.	1,764,000
British Bank of South America.	23,296,000
Commercial Bank of Spanish America.	4,324,000
Imperial Bank of Persia (head office, Teheran).	7,172,000
Ionian Bank.	15,698,000
London and Brazilian Bank.	35,144,000
London and River Plate Bank.	46,854,000
Grand total.	£207,686,000

Organized under English companies' acts or royal charter (head office, London) for the purpose of promoting foreign trade generally:

	TOTAL ASSETS
British Italian Corporation.	£6,872,000
British Overseas Bank.	4,361,000
British Trade Corporation.	4,396,000
Hambro's Bank.	22,381,000
P. & O. Banking Corporation.	12,911,000
Grand total.	£50,920,000

CONTINENTAL OVERSEAS BANKS

A detailed survey of the efforts of countries in the field of specialized overseas banking is unnecessary as it would add little more to the observations made above on American and British experience. Even the Hollanders who had engaged in international commerce for centuries did not pass through the crisis of 1920 unscathed, and Dutch institutions, some of the strongest and oldest corporations of their kind in the world, suffered losses in their efforts to combine overseas merchandising and banking operations in the post-war period. The French, less experienced, also met with reverses in

their efforts to enter territories which were new to French financial interests. The Banque Française pour Brasil was compelled to suspend payment and terminate its branches in Brazil. Far more serious was the reverse suffered by the Banque Industrielle de Chine. This institution was in difficulties at the end of 1920, but early in the following year the Banque de Paris et de Pays Bas at the request of the Banque de France formed a syndicate to support the Industrielle de Chine. Because of continued difficulties the bank was finally compelled to take advantage of the moratorium act, and as a result the New York agency requested the superintendent of banks of the State of New York to assume control over the affairs of the local office.

In other countries, banks engaged in international business suffered reverses. Some of the more conspicuous cases were the Seventy-fourth Bank of Yokohama, the Banco Italiano del Uruguay, and the Bank of Barcelona.

CONCLUSIONS

From the foregoing survey of the organization of overseas banking in the great commercial countries of the world, it is possible to discern certain general tendencies. The private banks which before the war financed the greater part of international commerce have declined in importance as the big

incorporated banks initiated or expanded their overseas service. In every country specialized banks and overseas institutions were organized or expanded to meet what was considered a new state of affairs created by the war.

With few exceptions losses were suffered by all classes of institutions engaged in the financing of foreign trade. So sharp were the reverses endured by American financial and business interests that they have failed to appreciate the seriousness of the setbacks encountered by other nations. The causes of these losses arose from conditions both beyond and within the control of the institutions involved. The instability of foreign exchange, the uncertainty of the international political situation, the breakdown of business morality, were post bellum consequences which could not well be anticipated by the most conservative management.

On the other hand, in practically every country during the war and post-war periods, financiers adopted policies which were in violation of the principles of sound business and banking and which would never have been followed in normal times. American, British, and Continental financial interests departed from the policy of confining their activities to straight commercial banking and ventured upon the hazardous and hitherto avoided practice of simultaneously conducting commercial and investment or commercial and mercantile operations.

The error was also made of limiting activities to a particular area instead of financing trade in general. Thus, instead of diversifying risks they were specialized, and so many institutions paid dearly for the failure to observe the elementary rule of banking not to carry all the eggs in one basket.

Finally, in the light of experience, what judgment shall be passed on the value of the overseas bank as a form of organization for furnishing foreign credit? The ill success of the American Foreign Finance Corporation and of the British Trade Corporation have led many thoughtful bankers to condemn the special overseas bank. It must, however, be remembered that these super-organizations encountered trouble because of their very weight. Although they were supported by the strongest financial interests in their respective countries, both enterprises did not succeed because of the difficulty in accommodating the policies of such vast organizations to meet the kaleidoscopic changes since the war. A number of years before the war, the Germans made a strenuous effort to establish an all-powerful overseas bank known as the Reichsüberseebank, but the proposal proved too ambitious and had to be abandoned.

That overseas banks can succeed over a long period of time is amply testified by the history of such companies as the International Banking Corporation of New York and the Hongkong and Shanghai

Banking Corporation of London. These institutions, and many others of their kind, were able to weather the crisis of the past few years because of experienced personnel and adequate reserves developed in past years.

Although the United States has made rapid progress in developing a system of international banking, even greater efforts are needed. If the United States wishes foreign trade it must at the same time be willing to finance it, since commercial expansion cannot be accomplished by a policy of financial isolation.

CHAPTER VI

CORRESPONDENT AND BRANCH SYSTEMS

INTERBANK RELATIONS

The previous chapter has described the various types of institutions engaged in financing foreign business. These banks in carrying out the operations of deposit, remittance, and discount, must develop a system of relationships with institutions located in important business centers. Such a system of interbank relations is necessary in both domestic and foreign banking. These connections may be attained by banks through the use of either the branch or the correspondent system. The branch is an integral part of the parent bank, while the correspondent is a separate institution which is called upon to perform certain specific services. For the handling of domestic exchange and for the conduct of purely national business most of the great commercial countries of the world have developed the system of branch banking. In the United States the movement for concentration and the consequent development of branch banking has up to the present time made little headway

and so the correspondent system still prevails. However, in some of the larger cities of the East and especially on the Pacific coast branches are being established, but the movement is being vigorously opposed by the smaller bankers throughout the country.

CORRESPONDENT SYSTEM

As in their domestic dealings, most American banks conduct their foreign transactions through correspondents. This choice is due to the fact that in the United States under the independent banking system the volume of international business of each institution located outside of New York City is in most cases insufficient to support foreign branches. But even the majority of the large New York institutions prefer correspondents to branches.

Several factors should influence American banks in selecting their foreign correspondents. Naturally consideration should be given to the relative cost of service expected of these foreign institutions. In most countries there is comparatively little difference in the interest allowed on credit balances or in the charges exacted by the leading banks for issuing letters of credit, handling collections, or for performing other services. This uniformity is due to the close working arrangements which exist among banks in foreign money centers, especially in Europe. There is, however, a wide variation in the quality

of the services of these banks. Some have a more experienced personnel, a more efficient organization, a larger number of branches, or better local business connections.

BRANCHES OF FOREIGN BANKS

Great Britain has always possessed the greatest number of foreign branches. These were established not by the large joint stock banks, but instead by the powerful overseas banks, such as the London and River Plate Bank and the Hongkong and Shanghai Banking Corporation. Such branches were located mainly in the British colonial possessions, and not until after the war did the great joint stock banks invade the Continent. Since 1914 the Big Five have placed branch offices in the important money centers of Europe.

The leading commercial countries of Europe before the war had also developed foreign branch systems, but in no case were they comparable in size to the network which Great Britain flung to the four corners of the world. The German "D" banks and their overseas subsidiary companies or "Tochtergesellschaften" penetrated the Far East and South America and also operated offices in England and in adjacent countries. During the war most of these branches were seized or were voluntarily discontinued. With the close of hostilities many of these branches were reopened. No effort has so far

been made to re-establish a foothold in the former enemy countries, but the Germans have made a determined drive to regain their position in South America and in the Far East. In these fields the German financial interests suffered relatively little loss during the world crisis of 1919-1920, since fortunately for them their banking institutions in many cases were still sequestered and so had not been returned. In the past two years these banks have re-entered the field and have competed successfully against American, British, and French banks which were handicapped by losses sustained during the crisis of 1920.

French credit institutions before the war had little interest in foreign trade financing and so maintained few foreign branches. These were located mainly in the Levant and in the Far East. Several branches were at one time operated in the United States, but did not prove profitable and were soon abandoned. Holland mainly through its big banking-trading corporations has extended branches to the Dutch East Indies, the Far East, and South America.

Since the close of the war there has been a marked tendency for the stronger economic countries to establish branches or control banks in the weaker countries. For example, Dutch, British, and even French banking interests have bought out German banks, especially in the occupied area, and now

operate them either as branches or as subsidiary institutions. The same tendency may be noted in the case of Austria where the Laender Bank with its numerous branches throughout the old Austro-Hungarian Empire is now controlled from Paris, and the Anglo-Austrian Bank, operating in the same territory, is managed from London. This movement is the direct result of depreciating exchange, which, at a certain stage in its downward course, gives holders of a high valued exchange a greater buying power in the country with the depreciated exchange. Thus Dutch financial interests have been able to convert their guilders into marks and thereby purchase complete or partial control in German banks whose stock did not rise as rapidly as the currency depreciated.

BRANCHES OF AMERICAN BANKS

Before the war, there were practically no foreign branches of American banks. This retarded development was due not alone to lack of interest but also to the absence of legislation conferring the necessary powers upon banks operating under national or state charters. The National Bank Act contained no mention of the right to open foreign branches and hence such a step would have been *ultra vires* or beyond their specified powers. The National City Bank, inhibited from having branches under its federal charter, obtained a con-

trolling interest in the International Banking Corporation, a state institution, and through it operated a number of foreign branches, especially in the Far East. The right to extend foreign branches was granted by a few states, such as New York and Connecticut, and so several trust companies, including the Farmers Loan, the Bankers, and the Guaranty Trust Companies, opened offices in London or on the Continent.

The Federal Reserve Act in Section 25A permitted a national bank with a capital and surplus of one million dollars or more to establish branches in foreign countries or in the foreign possessions of the United States on making application to the Federal Reserve Board. This procedure is merely a formality in order that the Board can determine whether or not the applying bank possesses the necessary capitalization, and if so the permission has been automatically granted. This power to open branches, together with the right to hold stock in special overseas banks as described in the previous chapter, enabled American banks to establish the necessary machinery for financing international trade. At the beginning of 1921 American banks and banking institutions possessed about one hundred foreign branches, located mainly in South America and the West Indies. Since that time this number has been considerably reduced. Several of the European branches proved unprofit-

able because of intense local competition and were sold to other American banks, which merged them with their own branches. The collapse of commodity markets and the uncertain movement of foreign exchanges in 1920 and 1921 brought curtailment of business and heavy loss to American branches in South America and the Far East, and so a number of them were liquidated. At the present time American banking institutions, not including the private banks, operate only about one hundred foreign branches.

ORGANIZATION OF BRANCHES

A bank may organize a foreign branch by creating a new institution or by purchasing an existing bank. Most of the American banks, such as the National City Bank and the Guaranty Trust Company, have preferred the former policy, although it has necessitated the development of a new clientele. In other instances it proved more advisable to take possession of an already existing institution through buying it outright or controlling the majority of its stock.

In buying an established institution, at the same time its obligations are assumed by the new owners who should therefore give this matter serious consideration. It also proves troublesome to change the operating and accounting methods of an old bank. In buying an existing bank, the foreign

purchasers have no assurance that they can retain the native customers. As a matter of fact, these persons may be inclined to withdraw their accounts from an institution which has passed into the hands of alien interests.

ADMINISTRATION

The administration of a branch may be either local or from the home office. Especially in cases where the branch is partly owned by native capital, it may be administered by a local board of directors, composed of leading business men of the community. Local-stockholders and local directors will naturally support an organization in which they are personally interested. However, American banks have generally feared that such policy would lead to unnecessary meddling on the part of native interests, and so have preferred to administer the affairs of the branch directly from the main office. As a compromise, a local advisory board is sometimes created to aid the branch manager but not to interfere with his administration.

PERSONNEL

The obtaining of satisfactory personnel has proven one of the most difficult problems in conducting foreign branches.

A good branch manager must possess qualifications which are hard to find in one person. Besides being a thorough business executive, he must also

be a shrewd trader in foreign exchange, since such operations are necessary in his dealings between the local country and the home office. The manager must also be a careful observer of local economic conditions. He must possess a broad acquaintance-ship in the business community. At the same time he must be absolutely loyal to the home office and to the national interests of the country which he is representing.

As far as possible American banks have tried to follow the policy of staffing their foreign offices with United States citizens. They have been preferred in order to be able to furnish service along American banking methods and directly in the interest of American business. It is therefore customary to place an American citizen in charge of the branch and as far as possible in the positions of assistant managers. For this purpose several American banks conducted classes designed to furnish special training to prospective branch officers. These students were given instruction in foreign languages and technical banking subjects, and in addition were rotated throughout the departments of the home office in order to become acquainted with its methods. Regardless of the thoroughness of such training, it was usually hurried and not comparable in value with actual experience in the field. It was therefore an error to rush college students through such courses, then place them in

foreign branches and expect them to hold their own in competition against the staffs of seasoned veterans in the overseas branches of European banks. Because of the lack of American citizens willing and capable to enter branch service, it is often necessary for banks to obtain English, French, and Germans for associate managers or senior officers and to draw upon natives for tellers and clerks, since most of the bookkeeping and routine correspondence must be conducted in the local language. In like manner foreign banks, such as the Yokohama Specie, employ as bookkeepers and clerks Americans in New York, Englishmen in London, and Germans in Hamburg.

DISTINCTION BETWEEN AN AGENCY AND A BRANCH

The operations performed by a branch are determined largely by the attitude of the home office, which may desire a policy either of passivity or of competition. In the former case the branch is conducted simply to render service to the customers of the home office. These may obtain, through the branch, information on the credit standing of foreign business firms, reports on general conditions, and the performance of such commercial services as the selling of uncalled-for merchandise or the settling of disputes between American and foreign business houses. A foreign office which is confined merely to these activities cannot correctly be called a

branch but should rather be termed an agency, and the officer in charge an "agent." Actually he is simply a resident representative. These terms are used rather indiscriminately. The officer in charge of the New York office of a British bank is legally described as the agent, while the party in charge of the London office of an American bank is called the representative. The essential distinction between an agency and a branch is that the former deals through the native banks, while the latter enters directly into relations with local business houses.

OPERATIONS OF A BRANCH

A branch, in the true sense of the term, performs actual banking operations in outright competition with native financial institutions. These operations may consist of receiving deposits, granting loans, handling collections, discounting bills, creating acceptances, issuing letters of credit, trading in exchange, and emitting notes. The performing of the first mentioned operation is sometimes considered to be the legal test of whether or not an office is an agency or a branch. This distinction is recognized by the banking law of New York State, which prohibits the receiving of deposits by offices of foreign banks and hence they are called agencies. At times American banks are admitted to local clearing associations as in Paris. The performance

of these two functions of receiving deposits and clearing items is sometimes denied by local law to foreign branches, as will be explained below. The branch also presents items to local business houses for payment or acceptance, and is thus able to be of considerable service to American exporters by carefully following their instructions in delivering shipping documents to foreign buyers and protesting drafts dishonored by the latter.

Loans granted by foreign branches are under close supervision both by the home government and the parent bank. These loans made by the foreign office of a national bank must follow the same regulations as laid down by the government for the head office itself. Furthermore, in granting loans branch offices must carefully observe the rules prescribed by the home office. A manager is usually permitted to extend to any deserving applicant credit within a specified maximum sum of, say, one thousand dollars. Even these loans must be later reported to the home office, where they are reviewed by senior officers who then give instructions to branch managers regarding future loans to these customers. All loans above the maximum amount must be referred by the branch manager to the head office for its approval. Another method of controlling loans granted by branches is for the home office to establish not a general line or maximum amount of credit for all customers but to

determine a specific line for each local applicant. The manager is then expected to keep loans within this limit, but is usually given a discretionary power to exceed the line by possibly 10 per cent before referring further applications for credit to the home office.

Branch offices may also finance exports and imports by accepting drafts and issuing letters of credit. Under the authority of these letters, the branches can purchase acceptances drawn on the parent bank.

Branches are generally permitted by the home office to trade in foreign exchange. A branch manager at times finds it difficult to show profits by regular banking operations, and so is tempted to speculate on the exchange market. This policy often brings losses instead of profits and hence the home office carefully limits such operations.

Branches conducted in undeveloped countries, such as the Far East, usually issue notes for circulation. The International Banking and the Asia Banking Corporations both exercise this power under a broad interpretation of their state charters. The federal tax of 10% imposed on the circulating notes of state institutions does not apply to such issues in foreign lands. Nor does the state law require any reserve against such notes, although as a matter of fact a heavy reserve is actually carried by most American banks. This safeguard is necessary, for in times of financial uncertainty the natives

in the Far East mistrust all banks and demand cash for notes. For example, the failure of a Chinese note-issuing bank several years ago, led thousands of natives to present notes to the branches of American banks for redemption.

Foreign branches are often operated not to handle commercial business, but to perform tourist service. For this purpose a number of American banks have branches in London and on the Continent.

RELATION BETWEEN FOREIGN BRANCH AND HOME OFFICE

From the legal standpoint a branch, although conducting its operations in a foreign country, does not take on a separate existence but remains always an integral part of the parent bank. (*Federal Reserve Bulletin*, 1919, p. 952.) The same view was taken by the attorney general (A. G. 601), who held that "the parent bank with its branches is one association . . . and all transactions are regarded as those of one corporation or institution." In accordance with this view, the Federal Reserve Board refused to permit several national banks, as distinct and separate corporations themselves, to establish a joint branch in South America. British banks which are free of governmental control have organized such a system of joint branches, as for example the Lloyds and National Provincial Foreign Bank.

On the theory that the foreign branch and parent bank are not separate entities, creditors of one organization become at the same time creditors of the other. Obligations assumed by a branch must in case of necessity be undertaken by the home office. Furthermore, action may be brought against an American branch in a local court, or the suit may be carried against the head office before the judiciary of the United States.

A somewhat different situation arises when a branch maintains a separate legal organization. This step is taken primarily to anticipate or to circumvent hostile legislation on the part of the native government against foreign corporations. Under these conditions a branch legally dissociates itself from the home office by having assigned capital or becoming a registered foreign corporation, sometimes styled a *société anonyme*. For these reasons, the branches of Lloyds and the London County and Westminster Banks of London have organized their branches on the Continent into a separate institution. (See London Times Trade Supplement, June 11, 1921, p. 246.) As a branch thereby becomes a separate organization, the head office is freed of legal liability, but undoubtedly it would feel a moral responsibility for all claims against even an independent branch if it were hard pressed.

Because of this close legal relationship and consequent financial responsibility, the home office

exercises strict supervision over the operations of its branches. Traveling inspectors and auditors make frequent and usually unannounced visits to all branches to prevent irregularities and to maintain the accounting system of the branches and the home office in as close harmony as possible. Periodic reports are required.

Governmental regulation of banks is also extended to foreign branches. National and state banks are required to furnish complete data concerning their branches to the office of either the Comptroller of the Currency or the state superintendent of banking. These departments sometimes send their own examiners to make a personal inspection of the books of the foreign branches.

TREATMENT OF FOREIGN BRANCHES IN COUNTRIES OTHER THAN THE UNITED STATES

There is no uniformity in the laws of the various countries on branches of alien banks, and so it is difficult to arrive at generalizations on this subject. Some nations prohibit absolutely the establishment of branches of foreign banks, while other countries are more liberal and place foreign and domestic banks on practically the same basis. However, this policy is the exception and not the rule, for most countries permit the operations of foreign branches only under definite restrictions. Even these restrictions do not indicate the actual diffi-

culties in establishing branches abroad, for some countries have no restrictive laws on their statute books but through discrimination, as for example in Australia and Denmark, render it impossible to operate such offices successfully.

REGULATION OF FOREIGN BANKS IN THE UNITED STATES

There is no Federal legislation in the United States on the control of foreign banks, since this matter is regarded as local in scope, and so is left entirely to the discretion of the various states. State laws draw no distinction between the branches of alien banks and those of financial institutions organized under the laws of other states.

The absolute refusal of quite a number of states to permit the operation of foreign banks within their borders is due to the existence of the independent banking system and the opposition to branches regardless of whether or not they belong to alien or American banks. Most states give a qualified consent to the operation of foreign branches.

The regulation of foreign banks by the State of New York is especially important because of the natural desire of foreign financial institutions to maintain direct contact with the New York City money market through the establishment of branches. The present State law authorizes the superintendent of banking to license foreign finan-

cial corporations with an excess of \$250,000 of assets over liabilities for the purpose of maintaining agencies in the state. These offices may exercise such powers as, trading in exchange, issuing letters of credit and making remittances, but are not permitted to receive deposits, make discounts, or issue notes for circulation. These agencies, as they are described in the law, are also subject to examination by the state authorities in the same manner as domestic banks and in addition must pay an annual tax on the total amount of interest or compensation which they have earned or collected as a result of their operations within the state.

Within recent years there has been a growing movement in favor of liberalizing these restrictions on foreign banks. In 1920 the Legislature of the State of New York passed the Cotillo bill, but it was vetoed by the governor. Its provisions are interesting as they will undoubtedly form the basis for future proposals which may eventually become law. The Cotillo bill would have empowered a branch of a foreign bank with a capital and surplus of over one million dollars and with assets of one million dollars in excess of liabilities to receive deposits on the conditions that no more than three per cent interest should be granted and even this maximum rate to be allowed only on balances of over three thousand dollars. Accounts less than this sum could draw no interest at all. These

provisions would have met the usual objections against foreign branches that they are weak, irresponsible institutions and that they attract small depositors from the New York savings banks.

NEED OF RECIPROCAL TREATMENT OF FOREIGN BRANCHES

This subject of restrictions on branches of foreign banks is part of the greater problem of international economic rivalry. The war, far from allaying, has rather intensified the spirit of mercantilism which has found expression in protective tariffs, economic boycotts, and trade wars. In line with this general policy there is every indication that the restrictions on branches of foreign banks will be multiplied. A number of countries are seriously considering such measures against foreign branches as confiscatory taxation, rigid examination, and further curtailment of their powers. So far, these proposals have been held in check by threats of reprisals. In general, this policy is ineffective for it creates the wrong mental attitude on both sides. As a more desirable alternative, the League of Nations has urged a policy of reciprocal treatment of foreign branches in different countries. (See memorandum by Marcus Wallenberg.)

RECIPROCAL TREATMENT OF BRANCHES OF FOREIGN
BANKS

A complete *laissez-faire* policy in the matter of foreign branches cannot be expected of countries, for they undoubtedly should have the right to protect the interests of their citizens. These must be guarded against exploitation by foreign financial influences. Certainly a government should not stand idly by while the savings of its people are sent abroad. Also its banks are entitled to protection against unfair competition by foreign financial institutions. However, when they succeed in gaining business by more progressive methods than those followed by native banks, the latter are not justly entitled to aid from their government. Particularly is it important for New York State to liberalize its legislation regarding foreign banks. They should be encouraged, for their presence tends to broaden the discount market by increasing its membership, and to lower the rate of interest by bringing so much more active capital, and in this way the movement for making New York City the World's money market will be materially aided.

THE CASE FOR THE CORRESPONDENT SYSTEM

Every bank, whether in domestic or foreign business, must decide between the correspondent or branch system of conducting its interbank relations.

There is actually little choice for the smaller banks, since the volume of their business would not warrant the establishing of branches. The larger institutions are confronted with a real problem and are to-day giving serious thought to the subject. As indicated above, American banks in both the domestic and foreign relations have generally adopted the correspondent arrangement rather than the branch system, and so have chosen the policy of cooperating with other banks rather than competing with them. Several American institutions have entered upon very intimate reciprocal relations with foreign banks. A form of close correspondent relationship is the plan developed by the International Acceptance Bank of New York which has sold blocks of its stock to leading foreign banks.

The supporters of the correspondent system, whether of the loose or intimate type, claim a number of advantages. It is contended that foreign banks with their greater experience, more firmly established local connections, and often a vast system of branches throughout the country, can offer better service in making collections, handling documents, and especially in furnishing information on credit conditions in their own territory. The International Acceptance Bank in its annual report for 1923 states that its affiliated scheme has given access to credit and trade reports which have been of great importance in the readjustment period and

which otherwise would not have been available. Branches of foreign banks are usually unable to rediscount their paper with the central bank in the foreign country, whereas this facility could be utilized through the endorsement of a correspondent bank. Thus the correspondent system is said to give better access to foreign discount markets.

The leading argument advanced in favor of the correspondent as against the branch system is that the latter policy will cost a bank valuable business from abroad. Banks naturally will not select as correspondent abroad a foreign bank which at home is a competitor through its branches, but will prefer a non-competing institution. The latter by its passive policy thus gains profitable business in performing such services as trading in exchange, confirming credits, collecting items and handling documents for foreign correspondents. This thought was expressed in 1918 by Sir Edward Holden, then chairman of the London Joint City and Midland Bank, in an address which read in part as follows:

“Our fear is that we may make the foreign bankers unfriendly towards us by opening branches in their own countries in competition with them and that we may drive their business to Germany or New York. If this should ultimately happen, the opening of branches abroad by English banks will have acted prejudicially against London retaining her position as the financial center . . . Further, if we retain the friendliness of these foreign bankers, they will show a greater interest in their clients, dealing with traders in this country, than they would

show in case we became unfriendly by going into competition with them." — *Address to General Meeting*, Sept. 13, 1918.

The policy thus enunciated by Sir Edward Holden has been followed by his successor, Sir Reginald McKenna, who in his address to the stockholders in 1921 made the following observations:

"We have refrained from competing with our foreign friends in their own country and I cannot help thinking that we have gained their favor in consequence. We have no present intention of deviating from this policy, which, besides having the merit of enabling us to extend our relations with foreign banks, gives greater security to our domestic depositors by restricting our activities to our home fields."

THE CASE FOR THE BRANCH SYSTEM

The supporters of the branch system refuse to concede that better banking services as to credit information, shipping documents, and collections can be obtained through foreign correspondents. While it is admitted that foreign correspondents may be able to gather excellent credit data, it is contended that these banks will not make the information as freely available to Americans as to their own nationals in the same line of business. Branches, it is argued, are therefore needed to gather credit data and to promote American business interests which may otherwise be sacrificed to competitors. It must be remembered that this argument holds true only for territories which are covered not by native banks but by branch banks

of foreign countries competing with American business firms.

From the above argument is developed the oft-repeated assertion that foreign banks disclose to their own nationals the trade secrets of American business houses. These foreign banks, in collecting documentary drafts, obtain possession of the commercial invoices and the bills of lading from which trade information such as specifications and prices can be transcribed and filed away for the benefit of their own countrymen. This charge of violating trade secrets was levied especially against the Germans, but it is now the general consensus of opinion that even complete copies of invoices are of little value to competitors, unfamiliar with the exact style or quality of the goods shipped. It is the belief of many American firms that collections for their account are not handled by branches of British and European banks with the same care and tact exercised in presenting the bills of their own nationals.

A strong point in the matter of collections may be scored in favor of an American branch system abroad if the viewpoint is shifted from business ethics and banking practice to legal liability. An American bank does not assume responsibility for the acts of its foreign correspondents as agents, and so the former is not liable for the improper handling of documents and drafts by the latter.

On the other hand, a parent bank can be held strictly accountable for the errors of its foreign branch. Because of this continuity of responsibility, banks with foreign branches exercise greater care in protecting the interests of shippers. On this subject John E. Gardin, who developed the branch system of the International Banking Corporation and the National City Bank, in an address before the National Foreign Trade Convention in 1919 said: "Since we have had branch banks in South America, I cannot recall a single instance where merchants have lost anything through the delivery of goods without proper authority."

CONCLUSIONS

From the above discussion it would appear that the branch system is in some respects superior to the correspondent system from the standpoint of American business men. However, this conclusion does not hold from the viewpoint of the bankers. Since the inception of the foreign branch system, they have suffered considerable losses in the operating of foreign branches. Branches have often been placed in localities already heavily overbanked. Under such conditions an additional institution must try to win away business from other banks long established in the field. Reverses have also arisen from local credit extension on merchandise which collapsed in value and also from exchange

operations in currencies which underwent sharp depreciation. A number of branch offices in Europe have been conducted on a most elaborate scale by American banks, not to handle trade financing but to accommodate tourist business. Although these luxurious offices have in themselves a certain advertising value, their operation has proved very costly.

The inability of overseas branches to show profits has not been confined to American banks, for German institutions also endured heavy losses in developing the branch system in the quarter of a century before the War. (See Riesser, *German Great Banks*.) The English during the past half century, and possibly the Japanese in recent years, have been the only bankers to establish a foreign branch system on a paying basis.

In view of such financial losses, is the branch system worth while? Its supporters notwithstanding these losses contend that the branch system serves as a trade outpost for furthering American business and is absolutely essential for developing our economic interests overseas.

The various branches of British and Continental banks are to-day serving as the central unit for rallying the financial and industrial interests in each foreign country in a combined effort to regain the local market lost during the war. Furthermore, in South American countries and other markets where American and European interests are active

competitors, branch banks are often able to influence the flow of local business by their quotations on exchange. In the absence of American banks, rates as quoted by other banks, particularly branches of competing countries, may be so unfavorable that local merchants will prefer to do their foreign business in other currencies than dollar exchange. It may, therefore, be argued that American branches are needed to hold the trade won since 1914.

A purely nationalistic appeal appears in some of the arguments advanced above on behalf of branch banks. The same thought underlies the defense of the ship subsidy plan for developing our overseas trade by a strictly American merchant marine. A similar plea for nationalism is found in many of the arguments for a protective tariff. From the field of tariff controversy the doctrine of comparative costs may well be borrowed and applied to the subject of branch banking. According to this theory, nations should direct their efforts to the production of those goods which they can turn out with the least expenditure, and to obtaining other goods from countries which can produce them at the cheapest cost. Following this line of reasoning, there is little justification for the operation of branches in countries where the banking structure is already well developed and where the branch of the American bank cannot give service which will

be in any way superior. This thought is well expressed by the Irving Bank, which defends its choice of the correspondent system in the following words:

Co-operation not competition is the point which has been emphasized in these relationships because, after all, trade currents will be determined, directed and controlled not by institutions which come from the outside but by the well established and recognized domestic institutions of the particular country. Competition between the enterprises of different nations there will be naturally, and American business to be successful in world trade must include this fact in its plans, but clearly, it is not good business policy to strive to get, through competition, benefits which can be secured through friendly co-operation.”¹

On the same subject may be added the statement of Howard Ayres, who speaks from the standpoint of an American business man with years of experience in foreign trade: —

“A favorite theme, especially with those directly interested in that instrument of trade and those carried away by the exuberance of patriotism is the American bank, the need of it in foreign countries, and the difficulty of trading without it. It will be a good thing, of course, for all business men to have more bankers seeking commercial bills, but there will be no peculiar advantage to any one to have the new bankers and their funds of even nominal origin with the United States. There has not been at any time until the present any lack of banking capital for doing export or import business with any country under the sun, and all the facilities of existing institutions have been and will be again, extended without discrimination as to nationality to all business men in every country to the extent of their credit.”

¹ *Federal Reserve Bulletin*, 1919, p. 23.

The foreign branch of the American bank unquestionably possesses a function in undeveloped countries where existing banking facilities are insufficient to care for local needs. Under these conditions such branches can perform distinct services in both commercial and investment banking. Through their constant willingness to purchase drafts on New York a steady market for dollar exchange can be created, and general credit facilities along American lines can be offered. Also branches may be of a special value in directing the flow of American investment capital into international channels.

PART II
TRADE FINANCE

CHAPTER VII

COMMERCIAL CREDIT POLICY

PRINCIPLES OF CREDIT GRANTING

TERMS OF SALE

Goods are produced and sold no longer on a strictly cash but largely on a credit basis. The modern system of credit granting in the United States has been developed within a little over a quarter of a century and only recently has its operation been scientifically studied. Whatever the differences in practice, the underlying principles of credit granting are identical in both domestic and foreign transactions. Hence before examining the actual policies followed by business men and bankers in extending foreign credit, it is well first to consider the general principles governing the extension of credit whether domestic or foreign.

The general business relations between a buyer and a seller of goods may be stated in a document known as a contract of sale. These contracts may be long, formal agreements, as the Canadian and United States Grain contract issued by the London Corn Trades Association, or may be simply informal memoranda as used in the tobacco export business which is conducted largely on an honor basis. In

either case it contains stipulations concerning the quantity or quality of the article and the price for which it is purchased.

The contract of sale also includes the terms of sale, which express the credit relationship between buyer and seller. The terms of sale indicate the length of the credit period allowed to the buyer and the conditions under which he is required to make payment. A simple form of terms of sale would read: 2 per cent, 10 days net 60 days. Under these conditions a buyer receiving a bill of goods is allowed a discount of 2 per cent if he makes payment at any time within ten days. If he does not wish to take the discount, he may instead elect to pay at the close of the period of sixty days, when settlement must be made at the full face or net value without any discount. These elements in the terms of sale do not change with each specific transaction but are relatively standardized in the various lines of business. Among these diverse occupations there is a wide range in the terms of sale, due to differences in the credit period. In general, the terms of sale in manufacture are about three months, while in agriculture or in foreign trade they generally extend to six months.

METHODS OF SETTLEMENT

Not alone may there be a wide variation in the period of the credit, but also a possible difference

in the method of final settlement. An extension of credit may be evidenced by open book account, or by some form of business paper such as the promissory note or the accepted draft. As in the case of the terms of sale, the employment of these instruments may be governed by the custom or unwritten law in each particular trade or the necessities of individual cases. The operation of the terms of sale and the use of these instruments to a large extent determines the manner in which the entire business transaction is financed. Under the terms of sale quoted above, the buyer may choose either to pay cash, thus taking advantage of the discount, or elect the alternative of postponing payment until the end of the credit period. The choice between these two methods of settlement will depend largely upon the rate of discount offered by the seller for cash payment and the rate of interest demanded by the bank for a loan granted to the buyer. As the rate of the former is generally higher than that of the latter, the buyer will naturally borrow from his bank and pay cash to the seller. Conversely, in lines where the usual rate of interest is higher than the discount quoted, the buyer will waive the cash discount and postpone payment until the due date of the bill. Where cash payment is made, the buyer is being financed by his banker and is thus receiving bank credit, but where a settlement is effected on time basis he is being

carried by the seller and is thus obtaining trade credit.

When the seller is called upon to extend credit, he may utilize his own funds or borrow from his bank. The former policy may tie up his working capital, and limit his operations. As an alternative he borrows from his bank. His bank loan may be supported by collateral or it may simply be an unsecured loan in the sense that it is non-collateraled but based rather upon pure credit. Such unsecured loans may be evidenced by a promissory note signed by the borrower who is thus receiving accommodation on the strength of his own credit standing. Straight single-name notes are usually employed when the borrower is selling goods on open account and so has no tangible obligations which he can turn over to his bank. If, however, he is receiving promissory notes or acceptances from the purchasers of his goods, he may discount this commercial paper at his bank. Thus it is seen that the burden of financing a transaction may be carried by one or more of the following parties: the buyer, the buyer's bank, the seller, or the seller's bank.

PARTIES TO A MANUFACTURED EXPORT TRANSACTION

It must not be assumed that export transactions involve only the buyer and the seller, for in addition to such direct exporting, a considerable part of

foreign trade is handled indirectly. The intermediary parties then are agents, commission houses, and merchants operating either in the country of the seller or of the buyer. These middlemen often are mistaken for one another, but each performs a separate function in the international movement of goods. The services of agents are employed especially by sellers of manufactured goods. These are placed in foreign markets by the agents or representatives, who collect a fee for this work from the manufacturers.¹ Commission houses on the other hand are retained not by the sellers but by the buyers on whom therefore falls the burden of paying for the intermediary or really brokerage service. The commission house, therefore, differs from the agent in that the former acts for the buyer and the latter for the seller. Differing from both these parties is the merchant who buys and sells for his own account and therefore operates for profit rather than commission. The large merchant house with considerable capital resources plays an important part in financing trade. Goods are imported to Far Eastern merchants who in turn sell to dealers and storekeepers on liberal credit. Thus foreign trade in manufactured goods may be financed through commercial credit extended

¹ A technical distinction is sometimes drawn between an agent and a broker, in that the former is considered as possessing the exclusive right to sell the exporter's goods, while the latter holds no such power.

by the manufacturers of finished goods or the merchant dealers in imports and exports. However, the greater part of foreign trade is financed by banking credit extended to the manufacturer or to the merchant.

PARTIES TO AN AGRICULTURAL EXPORT TRANSACTION

As a number of distinct stages are necessary in the movement of agricultural products from the growing area to the foreign market, this end cannot well be attained by direct export relations involving merely the buyer and the seller. Hence agricultural products are exported indirectly through intermediary parties, whose number varies according to the business practice established in the handling of each commodity. In former years it was the custom for Liverpool and Manchester spinners to send their agents into the cotton belt to buy the product directly from the farmer or the plantation owner. While a certain amount of cotton is still handled in this way directly from the American producer to the foreign consumer, most of the business passes through several intervening parties. The grower quite generally disposes of his crop to a factor who may sell directly to an exporter on the seaboard. However, the transaction may also involve a cotton merchant who stands between the factor and the exporter or shipper.

At times the cotton merchant does not buy cotton through a factor but through his own agent who negotiates directly with the producer. Thus the movement of cotton from plantation to seaboard may involve such parties as producer, factor, merchant, and exporter.

Likewise American grain consigned to foreign markets is handled by various intermediaries. The exporter may buy his grain at several places, such as the producing area, the country elevator, or the seaboard. When sold at the last named point, grain is moved by certain intermediaries known as "fobbers," who buy from the growers in the interior and then sell to the exporters on the seaboard. Fobbers sell on terms of f.o.b. (free on board) vessel at an Atlantic or Gulf port, hence the origin of their name. No sharp distinction can be drawn between grain exporters and fobbers, since their two functions are often jointly performed by grain houses. Whether engaged solely in exporting or in a mixed exporting and fobbing business, these firms do not buy and sell on a commission basis, but for profit, and so assume the risk of price fluctuations. These price fluctuations have been most acute since 1919, when large profits were followed by crushing losses which made deep inroads into the number of agricultural exporting houses.

In the past few years, there has been a growing tendency toward direct exporting and a reduction

in the number of intermediaries. The most noteworthy movement toward more direct and more orderly marketing on the part of the sellers of agricultural products has been the development of cotton co-operative associations which aim to bring together producers and exporters. The grain trade has witnessed a determined effort by foreign purchasers to develop a more direct buying policy. Before 1914 it was customary for foreign firms to buy their grain from American houses, but within the past few years there has been a tendency for the former to establish American buying agencies which are either largely controlled or entirely owned by such foreign interests.

The movement toward direct marketing has made considerable progress in the meat packing industry. Even before 1914 the so-called "Big Five" operated in London, Liverpool, Glasgow, and Paris, through distributing companies organized either as branches with the same name as the parent concern or as subsidiaries.

CASH PAYMENT

How the credit burden can be transferred by the exporter to his bank through discounting and how the importer can shift this task to his bank by means of the letter of credit, and the authority to purchase will be discussed in Chapters XI and XII. For the present, attention will be directed to the credit

relations between buyer and seller. The terms of payment for a bill of goods may be either cash or time. Cash payment may be demanded by the seller at different stages of the transaction. It may be required as soon as the order for the goods is given, upon the completion of manufacture, or upon delivery at a point in the country of either the seller or buyer.

Cash terms do not necessarily imply the payment of actual money at any one of the successive stages mentioned above, but may also mean the equivalent of cash as stated in a guarantee of payment by a well-known bank. This institution may express its binding guarantee to the exporter in an instrument known as a letter of credit whose operations will be described below.

Naturally, cash payment is the most favorable form of settlement from the standpoint of the seller, since he thereby obtains his money at once and as far as he is concerned the transaction is then closed. On the other hand, this method of payment imposes certain difficulties upon the buyer, for he is compelled either to tie up his own funds over a considerable period, at times long before he receives the goods, or borrow from his bank. Cash payment is particularly onerous to the foreign buyer if he is conducting his business in a country with poor banking facilities and consequently high interest rates. Therefore, if the buyer must pay ten to fifteen per cent for

interest on money borrowed from his bank, he does not regard a cash discount of two per cent from the seller as an attractive inducement. Also arranging for a letter of credit through a bank adds to the cost of the transaction.

So far it has been assumed that the buyer is dealing with a reliable seller. However, the latter may fail before the goods are manufactured and the remittance sent by the purchaser is lost, or the goods on delivery may prove unsatisfactory, and often no redress can be obtained.

Importers, especially those with unquestioned credit, resent a demand for cash payment. Such terms are considered humiliating and show want of confidence. There is indeed ground for such resentment when sellers insist upon cash terms from buyers of unimpeachable standing, such as foreign railway companies, municipalities, and even governments.

OPEN BOOK ACCOUNT

Although the open book account is a credit instrument in the sense of evidencing a credit transaction, it presents several disadvantages from the standpoint of the seller as the credit grantor. While a book entry may be produced in court as a legal record of debt, nevertheless it is not as good evidence as an instrument signed by the debtor himself. Moreover, a charge entry does not necessarily carry with it any definite statement of the maturity of the

bill and so the seller is tempted to delay payment. For these reasons the open account method, although common in granting domestic credit, is not unduly used in financing foreign business. In this field the open credit relationship exists chiefly among commission houses dealing with their agencies or with well-established firms in whom there is unquestioned confidence. Open credit is often extended by sellers to buyers in adjacent countries. Before the war this form of credit existed quite generally among firms in Europe where business relations were as close as though on a domestic basis. Transactions between the United States and Canada to-day are seldom financed by letter of credit, but usually on open account.

The cash and the open account methods thus present certain difficulties to the buyer and the seller respectively. In each case one party must carry the financial burden. If the seller obtains funds from his bank, this accommodation will be based on his own direct obligation, since a bank does not generally care to grant a loan on "accounts receivable" or book entries.

SETTLEMENT BY DRAFT

Settlement by means of the draft has distinct advantages over the open book account from the standpoint of the seller. The draft has a definite date of maturity and so the seller, as creditor, can

more readily enforce his claim against the buyer as his debtor. Furthermore, the seller is in a better position to obtain an advance from his bank through the discounting of the draft. For these reasons the draft or bill of exchange is the most convenient means of settlement in foreign trade. The exporter draws upon the importer or a bank. The bill is payable either at sight or on time, and so title to the underlying shipment as evidenced in the form of a set of shipping documents is transferred either upon immediate payment or upon acceptance and payment at a later date.

Hence there are two ways of settlement on a draft basis:

Sight draft attached to documents, known in abbreviated form as "S/D", or time draft attached to documents, symbolized as either "D/P" or "D/A". Terms on an "S/D" basis involve little credit extension by the seller, since payment is made upon sight or presentation of the documents to the buyer. True, an element of credit risk may arise when goods are shipped to a port where little or no market exists and where the importer takes advantage of this situation by refusing the shipment and then hoping to buy the merchandise at a sacrifice price. On a "D/P" basis, the documents are not delivered to the purchaser until he has paid the draft in full. Under these terms the seller does not yield title until actual receipt of payment. Selling

on "D/A" terms necessarily carries greater risks, since documents are surrendered upon acceptance of the draft by the buyer while payment is deferred until a certain period of time after the acceptance of the draft. These terms are, however, employed in dealing with customers of known standing or when selling in a dull market.

LENGTH OF CREDIT PERIOD

The duration of foreign credit must necessarily be longer than the period of domestic credit in order to make due allowance for the transit time for both the goods and the remittance. Thus, in the case of a transaction between New York and Buenos Aires, 30 days must be allowed for shipping the goods and a similar period of time for remitting the draft in payment. A study of the credit period in international trade, made by the author for the Federal Reserve Board in 1922, indicated that the terms granted by American exporters average between 90 and 120 days. (*Federal Reserve Bulletin*, 1922, p. 795.)

American firms engaged in foreign trade are often charged with illiberality. This allegation is not well founded, since American export merchants for many years have been extending credit on favorable terms to business houses all over the world. It is undoubtedly true that many American manufacturers and merchants who entered foreign markets for the first time after 1914 took full advantage of

their strong position as sellers and the dire necessity of European governments as buyers to insist upon payment either by cash or letter of credit. These terms continued to hold even after the close of the war and until 1920, which year witnessed a collapse in commodity prices and a change from a buyer's to a seller's market. Since that time drastic terms can no longer be demanded.

These tendencies are well illustrated in the effect of the changing economic conditions since 1914 on the terms of sale in the grain export trade. Before the war, grain was sold largely on the basis of sight draft on buyer. Under these terms the exporter drew his bill upon the importer, who paid it on presentation. During the war, grain was sold to the belligerents largely under letters of credit, which enabled the seller to draw on a bank instead of the buyer and so gave even stronger assurance of payment. During the past few years the terms have been sight draft to the Continent, while to the United Kingdom as follows:

Seven-day sight draft with shipping documents attached on shipments from Atlantic ports north of Cape Hatteras.

Fourteen-day sight draft with shipping documents attached on shipments from Atlantic ports south of Cape Hatteras.

Thirty-day sight draft with shipping documents attached on shipments from Gulf ports.

The differential in the length or tenor of the draft varies with the period of shipment and is aimed so as to maintain some correspondence between the date of the payment of the draft and the arrival of the grain.

During 1923, with the continuation of unfavorable market conditions for sellers, there was a movement on the part of buyers in some countries to demand more liberal terms of sale. Thus Italian millers have insisted upon deferring payment until the arrival of the steamer carrying the grain. Some foreign buyers have demanded even more liberal terms and have insisted that the credit burden be largely assumed by the sellers.

United States firms, particularly the members of the North American Grain Association, have generally refused to accede to these requests for credit extension, although some of the American branches and subsidiaries controlled by foreign interests have been willing to grant credit to continental buyers on such terms as half payment on arrival of steamer, and the balance at 60 days' and even 90 days' payment.

Although the terms of payment offered by American sellers have become more favorable to buyers, nevertheless they still cannot be compared in liberality with those offered by European exporters before 1914. In those days it was quite common to sell on open account and defer settlement for periods

ranging from one-half to five years, especially in selling machinery or other forms of fixed capital. The unsoundness of such terms is obvious. Although they stimulate sales, in the long run they fail to increase profits, for the longer the period of the credit the greater the element of risk and the possibility of loss. In the years before the outbreak of the war, there was a growing appreciation of the dangers of over-extended credits even by the Germans, who had been the worst offenders in this respect. Long-term credits can no longer be granted by German exporters, and in fact other European sellers also lack the resources of prewar days. Hence in general credits of American firms have tended to become longer and extensions of European houses have become shorter, so that to-day there is relatively little difference.

GENERAL FACTORS DETERMINING AN INTELLIGENT CREDIT POLICY

Credit terms have thus passed through several cycles, from the open account system of prewar days to cash payment during the war and the period immediately following. The pendulum has thus swung to both extremes and now moves with uncertainty. The credit man must therefore follow a mean between two extremes. He knows full well that in these days of economic instability there are few international firms entitled to credit on open

account. On the other hand, he realizes that cash terms cannot be demanded from all.

The present situation is well described by Mr. L. R. Browne, credit manager of the International Western Electric Company, in an address which reads in part as follows:

"The seller's market has departed and is a thing of the past. Those happy days when one's products were not sold but were 'allotted' to eager buyers on any terms are not with us now, for which in the light of their aftermath we should be truly thankful. We are down again to the healthy necessity of getting the business away from the other fellows by every fair means possible; and the cash with order, letter of credit attitude is not one of these methods if we are to succeed."

The credit man must therefore establish an intelligent policy based upon a wide range of factors, both general and specific.

True, it is impossible to form a generalized judgment of the credit standing of all firms in a certain country or particular trade, since there is a marked difference in their ability and also their willingness to meet obligations. These elements can be determined only by a close study of each case. However, certain general factors should be considered by credit men in arriving at a proper policy to be pursued.

To a large extent the exporter in formulating his credit policy must be governed by the established custom of the territory in which he is selling. Cash payment may be demanded in the Far East, where

this form of payment is the rule. On the other hand, in South America most business is conducted on credit. Even the retailer in selling a pair of shoes is frequently compelled to give his customer 30 days' credit. The retailer then expects credit from the importer who in turn feels he is justified in requesting credit terms from the foreign seller.

The efficiency of the overseas communication of a country will naturally influence the period of credit which it should receive. If goods can be delivered by fast steamers, merchants may carry smaller stock, may expect a quicker turnover, and so do not need long credits. But if a country has poor service and only infrequent calls, the turnover is slow and more liberal terms must be allowed.

Agricultural countries are often dependent upon one crop, and its failure or a decline in its foreign market directly affects the purchasing power of such a country. The Cuban situation since 1920 well illustrates this economic relationship. Cuba is the world's largest producer of cane sugar which constitutes 90 per cent of the island's exports. The collapse in the price of sugar in 1920 so impaired the buying power of Cuba that at one time merchandise worth \$80,000,000 lay rejected in the warehouses.

Conversely, a fully developed nation such as Great Britain, exporting largely manufactured goods, has a rapid turnover and so is in a better position to meet her obligations on short time. Furthermore, such

a manufacturing country has usually developed a diversified production and a varied market, and so is less influenced by the vicissitudes of business in any one line.

The solvency of any firm is directly affected by the relation between consumption and production both in its particular line and in general business. This fact was amply proven in the crisis of 1920 when prices reached their peak and then collapsed. In the preceding war period goods were so scarce that orders were only partly filled and so many foreign importers placed orders far in excess of their real needs. With the fall in international price levels, many buyers were loaded with expensive merchandise which had no market.

The disorder in exchange, whether European, Oriental, or South American, has added a speculative touch to all international business. Many firms, suffering losses from curtailed operations after the crisis of 1921, have sought to recoup through foreign exchange speculation. These ventures have often been financed through credit granted by foreign firms for legitimate commercial transactions. This speculation is not necessarily direct but is usually indirect. For example, an importer in a South American country of unstable exchange naturally seeks to make his remittances to New York creditors when the value of his currency is high and so will command a greater amount of dollars. Should

his exchange be low and so have a smaller value when converted into dollars, the South American will often seek to postpone settlement in the hope of a more favorable rate, and then he enters into the dangerous game of exchange speculation.

Another important factor influencing credit granting to buyers is the extent of competition among sellers. An exporter who is handling non-competitive products can usually dictate his terms even to the extent of cash payment, while a dealer in competitive goods is forced to grant concessions. These need not necessarily be made in the form of easier terms of payment, for a seller may instead either quote lower prices, or maintain his terms and his prices but offer a commodity of a quality superior to those of his competitor.

ORGANIZATION OF A CREDIT DEPARTMENT

The credit department, whether in a commercial house or in a banking institution, whether concerned with domestic or foreign business, is organized essentially for the purpose of gathering, filing, and analyzing credit data. The credit department of a bank possesses the additional function of disseminating this information to its customers or to other banks. The credit department of a commercial house has also a special task in collecting overdue accounts. Investigation or the gathering of credit data is the first operation to be performed by the

credit department. This step may be taken immediately upon receipt of an order from a new customer, or only after terms have been offered by the prospective importer and accepted by the exporter. On this point one large firm describes its policy as follows:

"We start an investigation immediately upon the opening of negotiations with a prospective buyer regardless of terms, which may be agreed upon for the first transaction because it may soon develop into an account where credit terms will have to be considered." (*Federal Reserve Bulletin*, 1922, p. 79.)

Credit data thus gathered must be systematically filed and indexed, so as to be readily available. These files may group the credit data according as customers are steady, occasional or only prospective. Active files are regularly revised at about three or six months' intervals, while inactive names are rechecked only from year to year. The task of finally analyzing the data and determining the amount of credit to be allowed is the major function of the credit department and usually depends upon the credit manager himself, since he is directly responsible for the correct judgment of the credit risks.

CHAPTER VIII

SOURCES OF CREDIT INFORMATION

The previous chapter has considered the determination of a credit policy and has viewed the subject largely from the standpoint of the business man. International credit is also granted by banks to other banks or to business firms abroad, and so American financial institutions as well as business concerns must obtain information which will serve as a basis for their advances. This chapter will survey the sources of credit information as found in foreign countries and the channels through which such data may be obtained.

THREE "C'S" OF CREDIT

Judgment of a borrower's willingness and ability to repay his obligations rests upon the three "C's" of credit, namely character, capacity and capital. The first, character, refers to the moral risk and is related to the debtor's willingness or inclination to meet his obligations. The second element, capacity, is the business risk and is connected with the borrower's financial and technical ability which will enable him to reimburse his creditors. Capital, the third "C", is also concerned

with the ability to repay and is the property risk, as evidenced by the amount of resources or assets which are in the possession of the borrower and which he can fully draw upon. The relative value of these three factors has long been the subject of active discussion among credit men whether interested in foreign or domestic business. Character has probably a more important place in foreign than in domestic credit, because of the difficulty in recovering claims in foreign courts from recalcitrant debtors, even though they possess the means of making payment. Hence the greater importance of their willingness to repay.

The war undoubtedly lowered business morality in many foreign countries where a merchant's word was formerly as good as his bond. The disturbed political and social conditions since 1914 have in a large degree brought about in many sections of the world a widespread degeneration in business ethics, as evidenced by the many cancellations of orders and repudiation of contracts in 1920 and 1921.

On the character and capacity of a foreign credit risk it is possible to obtain adequate data, but detailed information is usually lacking concerning his capital. This fundamental weakness in foreign credit information should be kept in mind in analyzing the value of the various sources.

INACCESSIBILITY OF FOREIGN CREDIT DATA

These sources of information can be found in all the important commercial centers of the world, such as London, Paris, Berlin, Amsterdam and Antwerp, which in the course of time have accumulated credit data on business houses and banks in every corner of the globe. This information is possessed by commercial reporting agencies, banks and business concerns interested in foreign trade. Contrary to the popular belief among many American business men and bankers, these credit data are quite complete and often as satisfactory as domestic credit information in the United States. The difficulty is their inaccessibility. Although foreign credit information is thus existent, it is to a large extent unavailable. Obviously, a foreign banker or business man will not be very willing to furnish full credit information concerning one of his fellow countrymen for the benefit of an outsider, and in the case of a client, data unfavorable to his credit are often withheld. But even in dealing among themselves foreign business houses believe in the principle, "let the buyer beware," and do not freely disclose credit information. In the United States both banks and business houses have developed a policy of mutually interchanging credit data, and the efficient operation of the American credit system is based on this principle of reciprocity. Such

interchange is practically unknown in Europe, with the possible exception of Germany, where the banks long ago adopted the interchange policy

FOREIGN LAW ON CREDIT INFORMATION

The inaccessibility of credit information is largely due to legal obstacles. In the United States the libel law in the past has been frequently invoked where the giving of information has worked injury to the party whose credit has been weakened. However, in recent years judicial opinion and business custom in America have adopted quite a liberal attitude in this matter, and have refused to interfere in the transmission of credit information unless deliberately slanderous in nature. In England this evolution has not been so rapid. For years the interpretation of the libel law was so rigid that one important commercial agency was unable to find a British printer who dared to make the plates for the rating book and so it had to be manufactured on the Continent. Even to the present day, commercial agencies in England have so doubtful a legal basis for their existence, that they have been reluctant to appear before the courts and have often preferred to arrive at some settlement of claims for damages rather than risk court action. In some of the Continental countries the courts have severely penalized parties giving unfavorable credit information even though it were true.

Not alone has the credit informer in foreign countries a liability toward the party whose standing is being questioned, but he is also under a legal responsibility to the person receiving the information. If it proves inaccurate and brings loss to the credit grantor, he has a claim against the informer. (See exception to this rule in *Banbury vs. Bank of Montreal*, 1918, A. C., 626.)

Because of these legal inhibitions, it is little wonder that foreign banks and commercial agencies couch their replies to credit inquiries in language most cautious. The uniform reply from a British bank will state that the party concerning whom information is desired is "moderately good for his engagements." The French bank will answer that the firm in question is "honorable" or "trustworthy" and will add a meagre bit of information carefully prefaced by the expression "on dit" (it is said). Also the heading of the reply letter will bear a caption which translated reads, "the information is furnished on a strictly confidential basis and without guaranty or responsibility." Many foreign banks answer all inquiries on separate sheets enclosed in an extra envelope marked "confidential" and bearing no indication of the source of the information. Such safeguards are employed in answering credit inquiries so as to prevent them from being offered as evidence in court.

The detailed investigation of a customer's credit

standing as practiced by our large city banking institutions is not followed abroad, and in securing information from foreign banks it should be borne in mind that a statement rating a firm "undoubted" or "highly regarded" and "good for engagements" often carries nearly as much weight as several paragraphs of detailed figures or information such as furnished by our own banks.

PROPERTY STATEMENT

The credit department of a business house or a bank can obtain information from a wide range of sources which may be either direct or indirect, depending upon whether or not the data are furnished by the borrower. In granting credit in the United States, the most important single source of information is the property statement filled out by the applicant himself. This document contains a detailed tabulation of all his assets and liabilities, together with other data useful in enabling the credit grantor to determine the line or maximum amount to be extended. Statements were introduced in the United States about twenty years ago, but only since the passage of the Federal Reserve Act has their use become general. The property statement is essentially an American device and has not yet been widely adopted in foreign countries. As a matter of fact, many foreign firms generally regard a request for a statement of their financial condition as in-

sulting. This attitude of mind is well reflected in the following reply made by a Liverpool firm to a New York house which requested a financial statement from the former:

"Aside from the fact that we cannot help considering your request for information concerning the most intimate details of our business as bordering on impertinence, we fail to see the value to you of any statement we may make. If you do not trust us sufficiently to accept our agreement to pay on a certain date, we cannot see how you are justified in taking our bare word as to our financial condition."

In some countries, especially those of Latin America, progress has been made in educating foreign business houses to the value of the property statement as a source of credit information and to the necessity of co-operation in soliciting credit data.

PUBLISHED STATEMENT

From these remarks it must not be inferred that financial statements are unobtainable. In some countries, incorporated enterprises are required to file a copy of their articles of association at the time of organization and thereafter a balance sheet from year to year. In the United Kingdom, financial statements of all corporations are filed at Somerset House in London where copies can be transcribed from the originals. These are not necessarily current, since they are filed but once a year. In some countries, these financial statements are published in one or more annual volumes, as the "Receuil Financier"

issued in Belgium or the "Handbook voor Cultuur en Handelsondernemingen in Nederlandsch Indie" (Directory of Investment and Commercial enterprises in the Dutch East Indies) compiled by Holland. These reports, however, are not general in other countries and so it is possible to obtain statements only from corporations whose stock is widely held.

VALUE OF STATEMENT

American business men and bankers especially are inclined to overestimate the value of financial statements in judging credit risks. In the United States, full reliance may be placed upon borrowers' balance sheets, for these are usually audited, and even when unaudited they can generally be considered trustworthy since both federal and state laws impose severe penalties for submitting false statements.

These safeguards do not generally apply to foreign financial statements. In the United Kingdom, statements of large borrowers are usually audited by chartered accountants, but this means of verification is not ordinarily pressed against small customers who are disinclined to pay the additional expense. Although there is no specific statute imposing a penalty for giving a false statement for the purpose of obtaining credit, nevertheless the common law can be invoked in the event of misrepresentation.

This was well illustrated in 1922 by the famous case of a very well known member of parliament and private banker, who was sentenced to a long term of imprisonment for falsifying items in his statement.

Outside of the United States and Great Britain, the practice of auditing is undeveloped and in many countries entirely unknown, so that items in a balance sheet are often merely an estimate. Penalties for submitting falsified balance sheets are seldom imposed, and as a result they are often untrustworthy. At times, assets are greatly overvalued in proportion to liabilities in order to impress prospective creditors. On the other hand, items in the financial statements are sometimes deliberately underestimated in order to conceal profits and so avoid onerous taxes. Foreign financial statements have been rendered all the more unreliable by the fluctuations in exchange, since assets and liabilities expressed in terms of rapidly depreciating or fluctuating currency are of little value to the credit man in his efforts to determine an exact line of credit. Even when the statements are honestly prepared, their interpretation is still very difficult, for there is little uniformity as to the meanings of the items themselves.

REPORTING AGENCIES

Because of these defects inherent in the financial statement it is necessary to seek reliable data from indirect sources.

Reporting agencies are to be found in most foreign countries. In each country there are usually one or two general agencies of major importance. They obtain their information by sending out letters of inquiry, or by examining government records on new corporations, bankruptcies, appointments of receivers, or dissolutions of partnership. The services rendered by these firms vary with their size. Most of them issue rating books containing summarized statements of the credit standing of a large number of business houses. In addition, these agencies will, at the request of subscribers to the service, undertake special reports on individual names. One difference between American and foreign agencies lies in their policy as to giving an opinion on the line of credit which the borrower is entitled to receive. American agencies, such as Dun's or Bradstreet's, furnish a detailed report but leave the determination of the line to the credit grantor. British and Continental agencies generally submit only a small amount of data but do state an approximate line which, in their judgment, the borrower is entitled to receive. A number of the foreign agencies will also handle the collection of bad accounts. This work is entrusted to a special debt recovery division which is part of the general organization of the agency.

In addition to the general agencies, which cover all trades, there are also numerous organizations

which study only certain lines of business, such as jewelry, clothing, hats, and shoes. These agencies are generally mutual credit protective organizations operating for the benefit of their members and the data assembled are not usually available to outsiders.

As explained above, the legal basis for these agencies, both general and special, is not well founded abroad. This insecurity finds expression in the guarded clauses inserted in the contracts to be signed by subscribers, who must usually agree that they will regard all documents, such as rating books and special reports, as the property of the agency, which may request their return at any time. In practice an agency rarely exercises this right, but it is reserved as a protective means in case of litigation. The subscriber also promises that he will use the data only in his own business and under no condition disclose the fact that the information has been supplied by the agency. It also tries to relieve itself of liability for incorrect information, since the subscriber to the service must agree to a waiver which states that the agency "while using every endeavor to insure accuracy does not guarantee the correctness of all or any of the information contained in its reports."

CREDIT RELATION BETWEEN EUROPEAN BANKS AND
THEIR CUSTOMERS

A second source from which information may be obtained concerning a foreign firm is its bank. The consideration of the foreign bank as a potential source of credit data will be confined to Great Britain and the Continent where such information has been compiled for many years.

In order to understand the European system of gathering and disseminating credit information through financial institutions, it is necessary to survey briefly the credit relations existing between the banks and their customers. One factor which has minimized the importance of credit information abroad has been the general stability of European business in the past. Many mercantile establishments have been handed down from one member of a family to another through successive generations. In fact, not a few business houses can point with pride to a history which may be retraced over several centuries. The number of new firms organized from year to year in Europe and the United Kingdom is small as compared with those organized in the United States. It should also be noted that hitherto it has been customary for English and Continental firms to maintain their accounts with only one bank. This institution has therefore an intimate knowledge of the financial history of its customers. Their good

features as well as their shortcomings in time become well known to the bank officers who generally remain long in the service of one institution.

CREDIT DEPARTMENTS IN FOREIGN BANKS

Credit departments were organized as early as 1848 by Continental banks, but in England where they are known as "intelligence departments" they have only recently been developed. The London Joint City and Midland Bank, under the able guidance of Sir Edward Holden, was one of the first institutions to adopt the credit statement. Before the war, few British banks took the trouble to keep written information on the credit standing of their customers. The reason lies in the difference in credit granting. British banks make advances largely on some form of collateral, while Continental banks are more willing to extend uncovered credits. The latter, therefore, must carefully analyze the personal credit of the borrowers, and so have developed excellent credit systems. But even these systems appear crude to the American credit man, for undoubtedly in the United States the machinery for gathering, analyzing, and disseminating commercial credit data has made the greatest progress due largely to the use of the single-name and so unsecured promissory note.

As in the case of American banks, these departments are conducted for the purpose of obtaining

credit information both for the use of the bank and also for the service of its customers. The European credit department differs from its American prototype in that the former is organized not so much for gathering information concerning its own customers as for securing data on outside names. The explanation of this peculiarity lies in the method of credit extension. In the United States, the bank grants credit to a borrower on the basis of his single-name promissory note. In England and on the Continent, a bank gives accommodation either in allowing an advance on some form of collateral offered by a customer, or in discounting a bill of exchange drawn by him and accepted by a second party. The bank discounting this bill is therefore directly interested in the acceptor, who is the primary obligor, and his credit standing must therefore be ascertained. A bank will also make a credit inquiry as a service for a customer who is considering the advisability of entering upon a business engagement with a party whose standing is unknown. While a foreign bank will thus investigate new customers, these are not studied as in the United States for the purpose of obtaining them as clients, for European, unlike American, banks do not actively seek new business.

CREDIT FILES

Another reason for the inaccessibility of credit data lodged with foreign banks is their inefficient method of filing and indexing. The writer in examining the credit department of one of the largest British banks found its data contained in weak, loosely-tied envelopes. On the Continent, the credit manager of a leading bank proudly stated that he possessed information on several hundred thousand names, but upon further inquiry it was discovered that most of these files were stored in a suburban warehouse and one of the supposedly "current" cards bore the date of 1896. Some of the more progressive banks have adopted American office methods and have installed new systems. These institutions revise their domestic files every three months, and their foreign files every six months, or at the least every year.

Banks on the Continent maintain a small staff of credit investigators who seek information through personal interviews. British banks do not generally employ such "reporters," but depend rather on correspondence as a means of obtaining credit data.

TRADE INQUIRIES

The financial position of a foreign firm is naturally watched by other houses in the same line of business, and inquiries in the trade often elicit valuable credit information. Such trade checking must be carefully

handled for reports may come either from firms which are indirectly connected with the party under inquiry or, on the other hand, from bitter competitors. As a result, the replies may be either over-friendly or unnecessarily hostile.

REPRESENTATIVES

American firms selling in foreign markets often employ the services of personal representatives in the sales territory. Some of the larger exporters, such as the meat packers, maintain foreign agencies which undertake intensive credit studies. The home office may ask the foreign agency to fill out a report blank concerning the standing of prospective customers as follows:

1. Name and full address.
 2. Their standing individually and as a firm or corporation.
 3. How long established.
 4. Report from the bank with whom they do business.
 5. Their estimated or stated financial worth in or out of business.
 6. From whom they purchase in the United States.
 7. Other references.
 8. Copies of financial statements.
 9. Full details as to the nature of their business.
- In general, an inquiry blank should disclose in-

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formation on the reputation of the foreign buyer in his local market, and the manner in which his business is conducted.

SOURCES OF INFORMATION IN THE UNITED STATES

The majority of American exporters do not conduct their business through their own agents abroad and so credit information cannot be obtained directly from foreign sources but indirectly through various channels in the United States. Undoubtedly, the best medium for obtaining credit information is the American bank maintaining international connections through foreign correspondents, or branches abroad. The credit department of such a bank will possess thousands of files which will throw light on the standing of buyers all over the world. This service is expensive to the bank, but is usually given free to its customers.

FOREIGN CREDIT INTERCHANGE BUREAU

American business houses selling in the same trade can of course furnish worth-while information concerning foreign buyers. While such an interchange of ledger experience would undoubtedly prove helpful, the practice is not generally followed. However, this object has to a large measure been attained through the efforts of the National Association of Credit Men. In 1919 it organized the Foreign Credit Interchange Bureau. It functions as a

clearing house for the interchange of the ledger experience of the members, which include several hundred of the most important American manufacturers, merchants, and commission houses and recently a number of banks. The operation of the bureau is best described in one of its circulars which in part reads as follows:

As each member is accepted by the Bureau, a number known only to the member and the manager of the Bureau is assigned. Forms for supplying the Bureau with a list of the member's customers in foreign countries and export commission houses in this country are provided. Nothing appears on this list of customers except the number assigned to the member.

When the list is received by the manager, he consults the card index files of the Bureau to ascertain if the name is already listed. If it is listed, the number assigned the member is then placed on the card bearing the name and address of his customer. When a name not listed appears on the list, a new card is made out, and the member's number is placed on the new card. This method serves a dual purpose, viz: it enables the Bureau to know where to secure information and in case of receipt of interesting information regarding an account, makes possible a guarded dissemination to only those interested.

When an inquiry is received, it is immediately looked up in the files. If a recent report is on hand, a copy is sent to the inquiring subscriber by return mail. If nothing is available from the files, an inquiry is sent to each subscriber that has had experience with the particular firm under investigation.

When a sufficient number of replies have been received, these are summarized on a standard report form which is then sent to all members who have contributed information. A typical report is reproduced as Illustration 8.

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FOREIGN CREDIT INTERCHANGE BUREAU

National Association of Credit Men

41 Park Row New York, N. Y.

The accuracy of this Report is not guaranteed. Its contents are prepared to good faith from members, and sent to you by this Bureau as your agent without liability for negligence in procuring, collecting, communicating or failing to communicate the information as gathered.

REPORT ON:

John Doe & Co.,

July 3rd, 1923 - July 10th, 1923

Sheet #25 - U

Inquiry \$3500

San Salvador

TERMS OF SALE

1. Open account on payable _____ days from date of
 - (a) Invoice
 - (b) Factory document
 - (c) Export document
2. Open account payable hereafter _____ days from date of
 - (a) Invoice
 - (b) Factory document
 - (c) Export document
3. Account guaranteed. Rev. _____
 - a. Voluntary remittance with order.
 - b. Ind for cash in advance only.
 - c. C. O. D. or R. T. T. R.
 - d. Cash against documents tendered L/C.
 - e. Cash against documents tendered L/C.
 - f. Bank acceptance of bank in the country of _____ days.
4. Bank acceptance of foreign bank at _____ days.
 - (a) Draft at _____ days sight through bank for collection d/b.
 - (b) Draft at _____ days date through bank for collection d/b.
 - (c) Draft at _____ days sight through bank for collection d/b.
 - (d) Draft at _____ days date through bank for collection d/b.
 - (e) Draft at _____ days sight through bank for collection d/b.
 - (f) Draft at _____ days date through bank for collection d/b.
 - (g) Draft at _____ days sight through bank for collection d/b.
 - (h) Draft at _____ days date through bank for collection d/b.
 - (i) Draft at _____ days sight through bank for collection d/b.
 - (j) Draft at _____ days date through bank for collection d/b.
 - (k) Draft at _____ days sight through bank for collection d/b.
 - (l) Draft at _____ days date through bank for collection d/b.
 - (m) Draft at _____ days sight through bank for collection d/b.
 - (n) Draft at _____ days date through bank for collection d/b.
 - (o) Draft at _____ days sight through bank for collection d/b.
 - (p) Draft at _____ days date through bank for collection d/b.
 - (q) Draft at _____ days sight through bank for collection d/b.
 - (r) Draft at _____ days date through bank for collection d/b.
 - (s) Draft at _____ days sight through bank for collection d/b.
 - (t) Draft at _____ days date through bank for collection d/b.
 - (u) Draft at _____ days sight through bank for collection d/b.
 - (v) Draft at _____ days date through bank for collection d/b.
 - (w) Draft at _____ days sight through bank for collection d/b.
 - (x) Draft at _____ days date through bank for collection d/b.
 - (y) Draft at _____ days sight through bank for collection d/b.
 - (z) Draft at _____ days date through bank for collection d/b.
5. Unaccepted draft.
 - a. Cash against shipping documents, draft receipt or warehouse receipt.
 - b. At customer's office.
 - c. At paying agency where bank.

MANNER OF PAYMENT

OPEN ACCOUNT

- A. Debit.
- B. Pay when due.
- C. Draw.

GENERAL

- B. Account settled by remittance.
- C. Account settled by remittance or cash payment.
- F. Account bill in dispute.

DRAFT

- M. Acceptance payment.
- N. Acceptance and pay promptly.
- O. Acceptance payment - delay payment.
- P. Delay acceptance - pay promptly.
- Q. Delay bank acceptance and payment.
- R. Make no claim.

WE RATE THE ACCOUNT

1. High.
2. Good.
3. Satisfactory.
4. Doubtful.
5. Unprofitable.

How Long Sold	Terms of Sale	Highest Recent Account	Date Last Dealings	Am't. Now Overdue (including outstanding drafts)	Amount Past Due	Number Days Past Due	Method of Payment (U.S.)	Rating Code	Credit Limited (If Any)	Credit Declined (Give Reason)	REMARKS
Years	Days										
2	11 60	212	4-'23	212	-		I	S			
7	90	1000	4-'23	856			I				
2	11 120	221	2-'23	188	188	60	J	T			Note 's'
	Note 'a'	Now convinced									that this acc't is undesirable. Purposely evading payment.
7	16 90	220	1-'23	-	-	-	I	S			
Years	Dft.	90	100	12-'22	-						
	11 90	110	9-'22	-	-		I	S			
1	1 10a	102	6-'22	80	80	9Mo.	C	T			
Years	75 60	306	5-'22	63	63	0	I				Note 'b'
Note	'b'	Succeeded in collecting all of									Wants and pay for this.
4	11 30	26	11-'21	-	-	-	U				Note 'c'
	Note 'c'	Returned goods in 1918.									Now trying to buy. We want cash in advance.
1921	15 60	89	11-'21	-	-	-	0	T			
4	16 60	362	10-'21	129	129	-	0	T			
	90	200	11-'20	-	-	-	0	T			
6	1 30a	89	12-'19	-	-	-	3	R			
1918	16 90	214	7-'18	-	-	-	I	S			
1922		116	9-'22	-	-	-					Payment of draft made promptly.
1920	1a 90	2139	12-'20	-	-	-	0				Would suggest caution.
1920	1a 30	300	11-'20	-	-	-					Only transaction took time to pay.
3	sight draft	116	1-'23	-	-	-					Paid 6/31/23

ILLUSTRATION 7

Credit Report

An informal interchange of opinions on foreign credit risks is also conducted through associations such as the Boston Export Round Table composed largely of export managers of firms engaged in foreign trade.

The interchange principle is also followed by the American Exporters and Importers Association which furnishes its members with credit data.

The value of the system of credit interchange is obvious especially in preventing foreign customers from overbuying, but the information is naturally limited to only those foreign firms with which the members of the organization have, or have had, business relations. Increase in membership is, therefore, most desirable, since it will have a cumulative effect upon the volume of credit information available.

TRADE ORGANIZATIONS — NATIONAL ASSOCIATION OF AMERICAN MANUFACTURERS

Although interested primarily in domestic business, the National Association of American Manufacturers conducts an extensive credit service department. It operates largely through several thousand correspondents including lawyers, bankers, and merchants who for a commission will submit a report on the financial standing of business houses in their respective communities.

Operating in somewhat similar manner is the Philadelphia Commercial Museum which for a number of years has been supported by the Government of the United States and State of Pennsylvania, for the purpose of advancing foreign trade.

COMMERCIAL INTELLIGENCE DIVISION

In line with the development of wider government service to American business interested in foreign trade, has been the establishment of a Commercial Intelligence Division by the Bureau of Foreign and Domestic Commerce within the United States Department of Commerce. The division assembles the reports prepared by the consuls of the Department of State and by the representatives of the Department of Commerce, and from this material prepares classified lists of importers in various lines of trade in all parts of the world. While these reports and lists cannot be regarded as constituting strictly credit information, nevertheless the data have proved most helpful to American exporters. Several organizations interested in collecting foreign credit data have their own representatives in the department for the purpose of obtaining the material direct.

COMMERCIAL REPORTING AGENCIES

A different type of credit service organization is the commercial reporting agency. While the various trade organizations described above conduct a credit bureau merely as an incidental service for their members, the commercial agency is operated primarily for the purpose of gathering credit information and circulating it among subscribers. The two largest agencies are the Bradstreet Company

and R. G. Dun & Co. They operate offices in important foreign centers, and elsewhere have thousands of individual correspondents who report either to the nearest branch or directly to the home office. In some countries the local branches have been dissociated from the home office and have been organized into separate companies, such as Bradstreet British Ltd. and Bradstreet Belge. The "Monitor Mercantil" in South America maintains only a loose correspondent relation with Bradstreet Company of New York.

WEAKNESSES IN FOREIGN CREDIT SERVICE

In 1922 the author, acting for the Division of Analysis and Research for the Federal Reserve Board, made a study of the sources of credit information, and for this purpose addressed a questionnaire to leading American business houses. They were asked to express their opinion on the merits and demerits of the American system of gathering and disseminating foreign credit information. The replies contained the following criticisms:

1. "The cost of foreign reports is too high as compared with domestic reports."
2. "Credit bureaus have not the money to develop the business properly."
3. "The major lack is failure on the part of many exporters to co-operate with organizations established for the gathering and dissemination of credit experience. If all manufacturers and exporters combined in the organization already established

for that purpose, the individual position would be strengthened and the danger of incurring unsafe risks would be minimized or eliminated entirely."

4. "Not enough information is available with regard to payment of drafts."

5. "Information given on foreign buyers is in most cases too old to be of any value."

6. "Lack of detailed and reliable information are the main defects of the present status of credit information."

7. "Lack of information as to how much credit has already been given to foreign customers by other exporters in this country."

8. "Duplication of information furnished by various sources based on correspondents having the same foreign bank sources of information." — *Federal Reserve Bulletin*, 1922, p. 798.

As indicated in this chapter, enough sources of information are available so that there should be no excuse for blindly undertaking credit risks. Although the fundamentals may be the same, the credit grantor should not forget that his client is many miles away, living under different conditions and with perhaps a different point of view. Through the foreign branches of American banks, and the constructive efforts of various groups of business men and bankers interested in foreign trade, and particularly in the credit phase of this business, information on foreign firms is gradually becoming more and more available with fuller details to conform to our own system.

CHAPTER IX

FOREIGN CREDIT INSURANCE

IMPORTANCE OF CREDIT LOSSES

When a manufacturer or a merchant, in selling goods abroad, assumes the burden of the financial transaction, he becomes the bearer of a risk which varies in degree with the standing of the buyer. The estimation of the extent of this risk, and the determination of the consequent amount of credit to be granted, may be based on an examination of the available sources of credit information as described in the foregoing chapter. Regardless of the value of these sources in aiding the credit grantor to arrive at an accurate judgment of the ability and willingness of a debtor to repay his obligations, the element of risk cannot be entirely eliminated. Its economic seriousness is not generally realized but it is undoubtedly true that, with the exception of the burden of war, credit losses constitute the heaviest wastage charge upon the business community. Such losses must necessarily be large, since 90 per cent of all business transactions are performed on a credit basis. The significance of bad debt losses, within the United States alone, can better be appreciated when

compared with the fire losses from 1912 to 1921, as seen in the following table. (*Federal Reserve Bulletin*, 1922, p. 667.)

FAILURE AND FIRE LOSSES FOR 10 YEARS

	FAILURE LOSS	FIRE LOSS
1921.....	\$750,200,000	\$332,654,950
1920.....	426,300,000	330,853,925
1919.....	115,500,000	269,000,775
1918.....	137,900,000	290,959,885
1917.....	166,600,000	250,752,640
1916.....	175,200,000	214,530,995
1915.....	284,100,000	172,033,200
1914.....	357,100,000	221,439,350
1913.....	292,300,000	203,763,550
1912.....	198,900,000	206,438,900
TOTAL.....	\$2,904,100,000	\$2,492,428,170

From the above figures, it is seen that credit losses over a period of ten years exceeded fire losses by \$411,671,830. These statistics represent only domestic losses, but they serve to show the seriousness of the problem of debt loss whether domestic or foreign. In fact, this risk is greater in overseas business, as explained above, because distance lessens the personal contact between creditor and debtor, and because the greater length of the credit term increases the possibility of loss. Moreover, the disturbed international economic and political conditions have further complicated the credit problem.

“DEL CREDERE” TRANSACTIONS

Because of these uncertainties, exporters have sought to transfer, or at least share, the credit risk with other parties. One method by which the exporter may relieve himself of the risk, is to draw his drafts “without recourse” before selling them to a banker. The writing of this expression under the signature of the drawer relieves him of the usual liability carried by such party to a bill of exchange. Ordinarily the drawee to whom the bill of exchange is addressed is the primary obligor from whom either payment or acceptance is first sought, but if he fails to pay or accept, the holder may then seek reimbursement from the drawer as secondary obligor. If this party has drawn the bill without recourse, he has thereby freed himself of responsibility for loss which must then be borne by the holder who is usually a discounting banker.

The discounting of a draft drawn “without recourse” is known as “del credere.” For this service the merchant usually pays a commission to the buyer of the bill, who thus guarantees the standing of the drawee. Before the war this practice was widespread in Germany, where “del credere” houses were organized especially for this purpose, and where the large banks followed a liberal policy in discounting without recourse bills drawn by business houses in which they held a direct interest.

British and American banks do not generally maintain such intimate relations with their customers and so are usually unwilling to discount "without recourse" bills. Banks have justified this policy on the ground that they receive only a small commission for their services in discounting drafts, while exporters derive substantial gains when their business transactions terminate successfully. Since the banks do not participate in the profits, they are naturally unwilling to share in the losses when they occur.

THE COMPRADOR SYSTEM OF THE ORIENT

The determination of the credit risk is particularly difficult for bankers and business men dealing with the Orient, because of such obstacles as distance, language, and social customs. In order to facilitate trade relations between orientals and foreigners, the comprador system has been developed, especially in China. A comprador is a middleman, or more accurately, a broker, who undertakes a variety of services, most important of which is guaranteeing the credit standing of local debtors.

The duties of these middlemen depend upon whether they are merchant or bank compradores. An American or a European firm conducting business in China, employs a merchant comprador who acts practically as a local sales manager. It is his duty not alone to obtain customers, but also to guarantee their commercial morality and financial standing.

In this respect the function of the 'comprador is somewhat like that of a factor. A bank comprador performs really the duties of manager of a local branch or agency. On behalf of the foreign bank, he receives funds, makes payments, collects items on local drawees, compiles credit information, and guarantees the reliability of the local employees of the bank. For such services he receives a commission of from $1/4$ to $1-1/2$ per cent on the amount of the business which he transacts.

To perform these functions satisfactorily the comprador should have adequate capital, thorough experience, and intimate personal relationship in the business community. In former years, dealings with credit brokers were based on verbal understanding, for they enjoyed an unquestioned reputation, but the collapse of commercial morality since the war has affected even the Far East, where the binding force of a business obligation has hitherto been proverbial. Oral agreements have therefore been replaced by written contracts, which in many cases require the credit broker to offer as a pledge for the fulfillment of his obligations security in the form of cash, stocks, bonds, or real estate.

CREDIT INSURANCE IN GERMANY

The Germans were the first to conduct credit insurance companies, which for a premium guaranteed the payment of bills of exchange and accounts

receivable. By the opening of the twentieth century, highly efficient systems of credit insurance had been developed by a number of German companies, notably the "Hanseatische" and the "Globus" concerns. They received considerable assistance from the German government, which was then bending every effort to expand its overseas trade.

CREDIT INSURANCE IN GREAT BRITAIN

Credit insurance in Great Britain was started by the "Securities Insurance Company Ltd." which sought to indemnify merchants against losses on bills of exchange. This form of insurance was later undertaken by a number of so-called "trust companies" which, however, found the business unprofitable and most of them failed. The passing of these firms was due to inadequate study of the risks assumed, and so this error was avoided by a syndicate of Lloyds' Underwriters, which in time conducted a considerable business in credit insurance.

The uncertain conditions in the post-war period tended to check the overseas trade of Great Britain. To meet this situation, the Trade Indemnity Company, affiliated with the British Trade Corporation (see p. 142), was organized to underwrite credit risks. It is to-day the only private company in England of any importance engaged in the business of credit insurance. At this point, mention should also be made of the government insurance scheme,

but a description will be deferred until a later chapter (see p. 436).

CREDIT INSURANCE IN THE UNITED STATES

Insurance to cover domestic credit risks was written in the United States as early as 1893, when the American Credit Indemnity Company was chartered. Some years later credit insurance departments were opened by the "Ocean Accident Guarantee Corporation Ltd." and the "London Guarantee and Accident Co., Ltd." and recently the National Surety Company has entered the field.

MEANING OF INSOLVENCY IN CREDIT INSURANCE

Foreign credit insurance itself may be defined as a guaranty undertaken by an assurer that an exporter selling goods abroad shall not suffer from losses arising out of the insolvency of foreign buyers. The question then arises, what is the meaning of "insolvency"? The definition of this term is to be found in the policy or contract of indemnity between the insurer and the insured. It usually covers such cases as bankruptcy, involuntary liquidation, disappearance of buyer, or inability to collect drafts at law. One American policy contains the following definition:

(1) A foreign debtor shall be considered insolvent under the terms of this policy when

(a) A petition in bankruptcy or insolvency (voluntary or

involuntary) shall have been filed in good faith against the debtor according to the laws of the country in which the debtor resides or has his business establishment.

- (b) The debtor shall have made an assignment of his assets for the benefit of his creditors.
- (c) The debtor's stock in trade shall have been sold under a writ of execution or attachment.
- (d) A writ of execution or attachment in the jurisdiction where the principal place of business of the debtor is located, in favor of the subscriber or any other creditor, shall have been returned unsatisfied.
- (e) The debtor shall have compromised with his creditors for less than the amount of his indebtedness to them.
- (f) A receiver for the debtor shall have been appointed and confirmed.
- (g) The debtor shall have absconded.
- (h) The debtor shall have transferred or sold in bulk his stock in trade without having made due and proper provision for full settlement of his indebtedness.
- (i) A foreign or international bank which has been designated by the subscriber becomes insolvent, while holding funds of foreign debtor in process of collection for merchandise insured under the policy.
- (j) A claim on account of goods sold and delivered to debtor shall be reported "uncollectible by law" and such report shall have been verified in accordance with proof of law hereinafter set forth or a certificate shall have been obtained from the Legal Department of the [insurance company].
- (k) The [insurance company] receives substantiated information as hereinafter defined as proof of loss, of an act of insolvency or any other act not herein enumerated committed by the foreign debtor which impairs the debtor's ability to make payment.

Note: Moratorium declared by any foreign government shall suspend but not release the liability of the [insurance

company]. There shall be no additional premium charge during the interim of moratorium.

In place of this rather lengthy statement, the leading British company has adopted a much briefer form, as follows:

“By the word “insolvency” wherever mentioned in this policy it shall be understood that either an adjudication in bankruptcy has been made or a composition arrangement in legal form has been agreed to by the creditors generally or a legal assignment has been executed for the benefit of creditors generally or in the case of a limited liability company an order has been made for the same to be liquidated, either compulsorily or under the supervision or a resolution has been passed in legal form authorizing voluntary liquidation provided such resolution is not for the purpose of reconstruction. In the case of debtors domiciled outside the United Kingdom insolvency shall be admitted to exist where in the opinion of the company such conditions prevail or shall be deemed equivalent to an adjudication in bankruptcy in the case of individuals or firms to a liquidation in the case of incorporated companies.

After 1914, many American manufacturers entered the export trade for the first time. Because of their inexperience in judging foreign credit risks, these firms naturally became interested in developing some scheme of protecting themselves against bad debt losses. This desire led to a rather ambitious proposal in 1918 to organize a \$50,000,000 corporation for mutual credit insurance. The plan was based on the assumption that banks engaged in foreign trade finance would freely give access to their credit files which would be the means of accurately

judging risks and fixing premiums. Banks, especially the larger institutions in the East, were generally unwilling to turn over these data, and so the scheme was abandoned. Instead, a smaller plan was initiated in 1919 by the Illinois Manufacturers Association. It organized the American Manufacturers' Foreign Credit Underwriters, which in turn now manages the American Manufacturers' Foreign Credit Insurance Exchange. The exchange is a co-operative organization which furnishes its members with a variety of services including insolvency insurance, credit ratings, and debt collection. Its activities are confined largely to South America and to some degree to the Far East, but little attempt has been made to include Europe because of its disturbed economic status.

From this statement, it is clear that such credit insurance does not indemnify the exporter against all of the many contingencies which arise in selling goods in foreign markets. For example, the exporter is not entitled to reimbursement if his shipment is rejected or his account unpaid because of a trade dispute with the buyer. Nor would a flat refusal of payment on the part of the foreign purchaser who still remains solvent come within the above conditions. Because of this limited definition, credit insurance is regarded as inadequate by some critics. However, it must be remembered that fire, accident, and other forms of insurance are subject to similar

restrictions and that an all-risk policy is to be found in practically no field. The success or failure of the credit insurance business will depend in a large measure upon the interpretation given by the insuring companies to the term insolvency. An unnecessarily narrow view will in the long run repel exporters who will in time feel that the protection is too small in proportion to the cost of the premium.

PURPOSE OF POLICIES

Policies are written in a variety of forms but the various types may be grouped according to the purpose of the policy, liability of insurer, division of risk, and collection of the account. Credit insurance may be carried for the purpose of covering the general business of the assured or merely for a specific transaction. General, or as the British term it "whole account" insurance, is based on the principle that the insured will bear the normal or ordinary loss while the insurance company will indemnify him against abnormal or unusual risks. This normal or first loss of the merchant is generally calculated as the ratio between his losses and gross sales during a period of, say, five years. If during the coming year the losses are in excess of this normal proportion the insured must then be indemnified for the difference.

Specific insurance may be carried in several forms. A "time" policy usually insures the solvency of

one or more customers over a period of one year. Another form of policy is specific not as to the period of sale to the buyer, but according to the method by which goods are sold to him. Hence, a policy may be issued to give protection against the final non-payment of an open account or the dishonoring of a draft.

LIABILITY

Policies may be written either for a limited or unlimited liability. In a limited policy the total liability of the insurer does not extend beyond the face amount. For example, an exporter insured under a general policy has incurred during the year losses amounting to \$10,000 in excess of his normal proportion, but his policy has a face amount of \$5,000 and so this sum represents the maximum which he can collect from the company.

An unlimited policy bears no face amount, and hence there is no limit to the sum of insurance which may be collected if losses prove excessive. Thus the merchant in the above case would be entitled to the full \$10,000 or even a greater sum if he could prove his claim. This type is no longer issued in domestic credit insurance.

COLLECTION

Policies are also written in collection or non-collection forms, depending upon whether or not the

collection of past due accounts is placed with the insurance company, which undertakes the function of collection not so much for its own profit, but as a service to its clients. These, however, may prefer to deal directly with their unwilling debtors and so take out non-collection policies. Where the policyholder thus elects to handle his own accounts, he is under the necessity of proving the genuineness of his losses.

Such proof of loss may be established by filing with the company a sworn statement reciting the details of the transactions and containing documentary evidence such as the invoice of goods, the dishonored bill of exchange itself, or an affidavit from a banker, consul, or reputable attorney located in the country of the insolvent debtor. In addition, the insurance company sometimes reserves the right to examine the books of the exporter for verification.

CO-INSURANCE

Policies may be so written that the insurer either bears the entire risk or shares part of it with the insured. The latter principle is known as "co-insurance." The proportion which is borne by the insured may be fixed according to a certain percentage or may be graded directly with the extent of the credit risk. Thus a merchant may be compelled to assume but one tenth of the liability on the best risk, and as high as two thirds in the case of a

customer of inferior rating. In theory, the amount carried by the insured should coincide approximately with the profit which would be derived from the transaction, while the sum covered by the insurance company should correspond roughly to the replacement value of the shipment.

While the co-insurance plan is usually adopted by companies insuring domestic risks, it is not general in covering foreign transactions. So in the event of loss the exporter is able to obtain reimbursement for the full value of the shipment, and in addition all costs of transportation together with his prospective profit.

RE-INSURANCE

Insurance companies make it a practice of entering into re-insurance arrangements or treaties with other indemnity concerns whereby the latter carry risks beyond a certain limit.

DOCUMENTS USED

The relations between the insured and the insurer are usually expressed in two reciprocal instruments. The former signs a document known variously as an application, contract, or warranted declaration and if accepted by the insurance company it issues the policy. The content of these declarations and policies differs according to the kind of policy issued.

In general, the application should contain all data

needed by the insurance company in judging the nature of the risk which it is requested to assume. This document usually calls for information concerning the terms of sale to buyers, period of credit granted them, average yearly export sales of the exporter, his aggregate net losses, and the largest individual loss.

The policy itself is a rather lengthy document, consisting of the agreement of the company and the conditions binding on both the insured and the insurer. The first part contains a statement of the period of the policy, premium, rate and amount. The second part includes the conditions relating to definition of insolvency, notification of claim, collection of accounts, and method of adjustment in case of loss. As a rule a separate policy is issued for each transaction. The American Manufacturers' Foreign Credit Insurance Exchange, since it deals solely with its own members and is in continual dealings with them, issues what is known as a "master policy," under which a separate certificate may be written. While the master policy includes the agreement and conditions defining the general relations between the two parties, the certificate covers a specific transaction to a particular debtor. The certificate is rather an abbreviated policy containing only the necessary details, such as the amount of the premium, the name and address of the debtor, the terms of sale, and the period of the

insurance. The conditions established by the master policy, although not repeated in the certificate, are made to apply to the latter by a statement which reads that, "the insurance is part of and subject to all terms and conditions embodied in master policy." This certificate is negotiable in form, and so may be attached to a draft in order, according to the expectation of the insurance company, to render it more easily discountable.

PREMIUM

The premium paid by the assured is usually calculated from the data contained in the application, and his charge will be determined largely by such factors as the terms of sale offered to the buyer and his credit rating. The terms of sale in turn determine the period of the insurance, for the longer this interval the greater the premium. Likewise the premium will also vary according to the extent of the credit risk. In classifying such risk, and so in figuring premiums accordingly, the ratings of the buyers may be taken from the books of some well-known commercial agency, such as Dun, Bradstreet or Seyd. One insurance company has developed its own rating book, known as a market guide, in which foreign importers are classified as high, good, and fair, according to their credit standing.

CRITICISM OF FOREIGN CREDIT INSURANCE

While domestic credit insurance has quite generally won the confidence of the business public, the system of foreign credit insurance has been the subject of sharp criticism by many credit men, bankers, and insurance experts. Credit men often consider this form of insurance as uneconomical. They contend that most companies refuse to insure poor risks and accept only good accounts which in themselves need no protection. A number of firms, therefore, prefer to adopt the principle of self-insurance by setting aside periodically special reserves against bad debts. This fund may be derived by regarding it as an element of cost, and so adding it to the price charged the purchaser of the goods. Many bankers object to foreign credit insurance on the ground that, by relieving the seller of responsibility for the standing of the buyer, there is a natural tendency to sell too liberally and so to extend credit too carelessly. A number of insurance experts doubt the feasibility of foreign credit insurance, because of the lack of actuarial data on which risks and consequently premiums can accurately be determined.

ADVANTAGES OF CREDIT INSURANCE

Supporters of credit insurance claim many advantages for the system. The prospectus of a British company states that ·

"Policies are issued insuring the payment of commercial debts, thus enabling the exporter to increase his present volume of trade without incurring greater capital responsibilities."

An American company set forth the following claims:

"Banks will be able to allow the local manufacturer more credit and he is not limited to his working capital.

. . . "Credit insurance adds another name to the paper and the bank logically is willing to give larger discount and to take an increased amount of the paper."

These advantages are all related to the value of foreign credit insurance in increasing the ability of the insured to obtain more working capital from his bank. This contention is based upon the assumption that banks give full recognition to the service of credit insurance. But in the eyes of the majority of bankers, especially those engaged in foreign trade financing, credit insurance has not yet justified itself. So far the business of insuring credit has not been generally profitable from the standpoint of the companies themselves. Even in the period of normal business conditions before the war, numerous attempts at credit insurance failed, and not even the British who have developed all forms of insurance, succeeded in placing credit insurance on a profitable basis. The companies organized since the war have suffered crushing reverses. In 1920, the crisis carried down to failure tens of thousands of firms all over the world. The effect of this debacle upon insurance companies may be appreciated from the

statement of several leading American insurers of domestic risks, that in 1919, losses amounted to three per cent of their premiums and in 1920, eighty-nine per cent.

FUTURE OF CREDIT INSURANCE

There is undoubtedly a need of credit insurance in the general scheme of foreign trade finance under future conditions. Because of the exhaustion of working capital in many countries, their ability to purchase goods will depend largely upon the liberality of the credit terms granted by the business houses and banks of the stronger nations. However, the longer the period of credit, the greater the risk involved, and so any system of reducing this risk will tend to increase the length of credit allowed to debtors. There is every indication that economic conditions will continue unstable for many years to come. Sharp price fluctuations, rapidly moving cycles of prosperity and depression will characterize the period of reconstruction until the political and social ills of the world are ameliorated. Conservative business hesitates to assume the risks which must be encountered in international trade. Especially is this true of the American manufacturer or merchant who has relatively little experience in foreign commerce. Hence the justification of credit insurance which assumes one vital element of uncertainty. A universal and effective system of

credit insurance would tend to check the downward swing of a panic, which is largely psychological in nature. In such a time, the creditor whose debts are insured would regard his financial position as relatively secure, and would not be inclined to join the general rush to liquidate assets.

But how can this system be made to function efficiently? Fundamentally, the insurer must develop a broad actuarial basis for judging the extent of business risks. These data have, so far, been lacking and as a result the cost of insurance has been poorly calculated, undue risks have been assumed, and so claims have often exceeded premiums. This information can be assembled through the co-operation of both business houses and banks which should pool their credit data in the interest of all parties engaged in foreign trade finance. Furthermore, close arrangements should be established among the various credit insurance companies of the United States, Great Britain and the other commercial countries of the world. Such international co-operation would place credit insurance on the same dignified plane now occupied by marine or fire insurance.

CHAPTER X

DOCUMENTS OF COLLATERAL

NEED FOR COLLATERAL IN FOREIGN CREDIT GRANTING

As shown in previous chapters, the element of credit risk is present to a much greater degree in foreign than in domestic business. This factor of uncertainty tends to decline in importance as the sources of information become better developed, and as economic conditions in general, and those in the foreign country desiring credit, tend toward stability. However, since 1914 there has been little progress in either of these directions, but on the contrary the system of gathering credit data is still paralyzed from the shock of war, and economic disorganization in many countries has become more pronounced. Hence, the granting of pure or unsecured international credit, limited in the past, is to-day even more restricted than ever, when compared with domestic credit.

Foreign credit granting is, therefore, largely a matter of collateral lending, especially so far as the United States is concerned. The security underlying these credit extensions is the international flow of goods, which are being moved from all parts of the

world to their respective markets. These pledged commodities may be either in transit or in storage, pending their ultimate manufacture or consumption. Under such conditions, title to the commodities is evidenced either by shipping documents or warehouse receipts. To facilitate further the transfer of ownership, use is made of trust receipts and of warrants. These documents will be considered in this chapter from the viewpoint of both their economic function and legal nature, with particular emphasis upon the changes wrought by the disturbed conditions of the war and post-war periods. Both export and juristic technique will be avoided, and attention will be directed to a consideration of these instruments as forms of collateral for the extension of credit.

SHIPPING DOCUMENTS

The movement of commodities from the American seaboard to a European port involves several classes of intermediary parties, such as the banker who finances the transaction, the shipowner who transports the goods, the underwriter who insures the cargo, and the consignee who receives it. These parties to the transaction have certain rights which require protection and at the same time certain liabilities which must be assumed. These are defined in what is known as the commercial set of shipping documents including the bill of lading, commercial

invoice, policy of marine insurance, and certain minor certificates. These papers are attached to the bill of exchange which then becomes documented or secured and, when covering the shipment of a staple such as cotton or grain, constitutes an excellent basis for credit extension.

BILL OF LADING — NATURE

The bill of lading performs three distinct functions. It is primarily a receipt signed by the carrier, whether railway or steamship company, which thereby acknowledges the acceptance of certain commodities. The bill of lading is, further, a contract containing the terms under which the goods are to be transported. In these two respects, the bill of lading concerns only the consignor shipping the goods, the carrier transporting them, and the consignee to whom they are being forwarded. The banker, or any other party extending credit on the strength of the goods, is interested in the bill of lading, rather as a symbol of title, which may be freely transferred to any holder, who thereupon becomes the owner of the goods represented by the document. Because of this characteristic of transferability, the bill of lading is regarded legally as a quasi-negotiable instrument. It is not considered a true negotiable instrument like the bill of exchange. This with each transfer confers upon the transferee a legal title stronger than that possessed by the previous holder,

since an additional party may be held liable in the event of non-payment.¹

CLASSIFICATION

In the performance of these functions, various classes of bills of lading have been evolved. These may be grouped according to such features as, qualification, liability, shipment, issuer, route, negotiation and number.

QUALIFICATION

As stated above, the bill of lading is a receipt for certain goods supposedly in satisfactory condition at the time of their acceptance. If these goods should in any way be damaged when delivered to the consignee, the responsibility may properly be charged to the carrier in whose possession they have been during the period of transit. The carrier is, therefore, careful to note any damage to the goods in the bill of lading, which may be qualified by a statement such as: "Ten bags torn and mended." The bill of lading is then said no longer to be "clean," but is now described as "foul." If the consignor offers no objection to the bill of lading when so qualified, he cannot very well press a claim later against the carrier for damaged condition of the goods.

¹ For a detailed consideration of bill of lading, see Bennett, U. P., *History and Present Position of Bill of Lading*; Poor, W., *American Law on Charter Parties and Ocean Bills of Lading*; Scrutton, Sir T. E., *Charter Parties and Bills of Lading*.

It has been the practice of shipping companies to limit their liability by stamping a general notation on bills of lading irrespective of the condition of the goods. Thus, a bill of lading may be stamped "not responsible for torn bags" regardless of whether or not the shipment has actually been examined for any defects. Such general notations protect the carrier against possible claim to damage and prevent the shipper from pressing his rightful demands. Banks as negotiators of drafts documented by bills of lading are interested in guarding the rights of holders and so insist that "bills of lading shall contain no words qualifying the acceptance of shipments in apparent good order and condition" (Regulations of the Commercial Credit Conference, see pages 258-260).

LIABILITY

Carriers further often limit their responsibility by inserting in their bills of lading a clause to the effect that "unless a higher value be stated, the value of the property hereby receipted for does not exceed \$100 per package." This type of bill of lading is known as a "released" bill, since it relieves the carrier of excess obligation. By paying a higher freight rate, the consignor may obtain a "full" bill of lading which gives him complete indemnity in the event of loss or damage to his shipment.

SHIPMENT

A bill of lading may state that the consignment has been "received from (the American Export Company), for shipment on board the steamship (Arcadia), from the port of (Boston), bound for (Havre)." Or the clause may read "received from (the American Export Company), for shipment on board the (Steamship Arcadia), *or following steamer*, from the port of (Boston), and bound for (Havre)." The steamship company has thus merely acknowledged its acceptance of the goods and its intention to effect shipment at some future date. The instrument is, therefore, known in exporting parlance as a "received for shipment bill of lading." It is often insisted that, since a bill of lading is more than a mere receipt but also a contract of carriage, it should contain the statement that the consignment has actually been "shipped on board the steamship (Arcadia)." A distinction may, therefore, be drawn between "received for shipment" or "received for transportation" bills of lading and "on board" or "shipped" bills of lading.

There is considerable doubt whether or not the "received for shipment" bill of lading is a true bill of lading. Two conflicting sets of opinions have been expressed by both American and British courts. In *Goldenberg vs. Cutler* (189 Appellate Division New York 489) and in *Marlborough Hill vs. Cowan*

(1921, I Law Reports, Appeals Cases, 444) an American and a British court, respectively, sanctioned the use of the "received for shipment" bill of lading, while in *Mora y Ledon vs. Havemeyer* (121 New York 179) and in *Diamond Alkali Export Corporation vs. Bourgeois* (1921, 111 Law Reports, Kings Bench, 443) other American and British courts considered it unacceptable. Nor is there any unanimity on this subject outside of American and British law. The "received for shipment" bill of lading has been recognized by the courts in Germany, but the rest of the Continent generally has failed to approve it.

Similar division of opinion exists among business and banking interests. Exporters naturally wish to consider the "received for shipment" bill of lading as an acceptable document, since it shortens the period of their responsibility for the shipment, and in many cases enables them to obtain payment for the goods without the necessity of waiting until the time when they have been actually placed on board a specific vessel. Importers, on the other hand, object strenuously to the "received for shipment" bill of lading, since it gives them no assurance that the goods have been placed on board and that they will be promptly shipped. The issue between importers and exporters came to a head in 1920, when world prices were collapsing and when buyers were seeking every technicality to refuse goods. The "received

for shipment" bill of lading was seized upon by many foreign buyers as a welcome opportunity to dishonor drafts on the ground that the accompanying bill of lading was not a true contract of carriage.

New York banks which had made payment to their customers on these drafts sought the opinion of the Transatlantic Associated Freight Conference, which included nine important lines operating from the Eastern seaboard. This organization issued the following statement:

"The procedure in this port (New York) of issuing bills of lading against the receipt of goods on the steamship company's dock, which bill of lading acknowledges receipt of the goods for transportation by a named steamer, and failing shipment by said steamer, with liberty to ship in and upon a prior or following steamer, is the only procedure possible under conditions existing here, and that it is not possible here to issue on board bills of lading.

"Export cargo moves through this port and indeed through all North Atlantic ports in large part from interior points. It passes from the railroad or other inland carrier into custody of the steamship company usually by lighters. Local cargo is delivered by trucks at such time as is convenient to the shipper. Cargo from inland points moves either on through or local bills of lading issued by the railroads at the point of origin, and in the case of through bills of lading, it is rare for any particular ship to be named for the ocean transportation. Any interruption or delay of this flow of cargo causes congestion and sometimes railroad embargoes on the port and exposes the shippers to demurrage charges. The steamship lines are compelled by these conditions to provide shedded piers at great cost to themselves and to receive and become responsible for the goods considerably in advance of loading on the ship, and

necessarily with more or less uncertainty as to the necessities of proper stowage; and the irregularity in arrival of shipments combined with the great accumulation of cargo, both inward and outward, on the piers, and for different steamers, render it physically impossible to guarantee loading by a particular steamer or to determine, until after a steamer is loaded and the dock checked up, whether any specific cargo has been loaded. These are the conditions which have made necessary the present form of bill of lading, which has evolved from the necessities of commerce in this, and generally in all other American ports."

ISSUER

Bills of lading may be further grouped, as either railroad or ocean, depending upon whether the goods are being moved by railway or steamer. A through bill of lading represents the movement of goods by both rail and steamship from an inland point to a port on the seaboard and thence to its foreign destination. The through bill of lading has been used extensively in moving carload lots of agricultural products from the South-West and Middle West to Atlantic ports on their way to Europe. This form of bill of lading finds much favor among exporters, particularly those in the interior of the United States, since they are freed of any further obligation over the shipment once it has been delivered to the railroad. The through bill of lading is quite generally employed instead of a local bill in shipping cotton from primary markets in the interior direct to foreign consignees.

As in the case of the "received for shipment" bill

of lading, importers abroad are opposed to the through bill of lading since it likewise offers no assurance of immediate ocean shipment. On these grounds, a British Court in *Harrison vs. Hamel* (Court of Appeals, Law Times, March 17, 1922) maintained the view that a tender by an exporter of a through bill of lading need not be accepted by an importer who could legally insist upon an ocean bill. The same opinion was also expressed in a recent case tried before a court in British South Africa.

This attitude toward the through bill of lading is in a way justified by the history of the instrument during the war. After 1914, the congestion on the Atlantic seaboard became so intense that goods often awaited shipment several months at a time. However, this cause of opposition to the through bill of lading has been largely removed by the return to a normal state of freight movement.

Another source of objection to the through bill of lading was its form as issued by the many railroads carrying freight from the interior of the United States. These companies had drafted documents lacking in uniformity and difficult of interpretation. These uncertainties have to a large extent been overcome by the Interstate Commerce Commission which, acting under the terms of the Transportation Act of 1920, prescribed a uniform through bill of lading to be adopted by "all common carriers accepting shipments in connection with ocean

carriers whose vessels are registered under the laws of the United States."

ROUTE

When an ocean carrier accepts a consignment, it is ordinarily supposed to be shipped by direct route. Bills of lading may, however, provide for other ways. However, more expeditious delivery may sometimes be obtained by routing goods through another port with more frequent sailings. The consignment is then sent by fast steamer to this port, where it is reloaded on another vessel. This procedure is known as trans-shipment. Bills of lading may also permit indirect shipment, which enables the master of the vessel to call at other ports before touching the destination point of the consignment.

NEGOTIATION

The previous classes of bills of lading arise as receipts evidencing the delivery of goods, and as contracts stating the conditions of carriage. It will be remembered that the bill of lading may also serve as a document of title when drawn in negotiable form. It is then called an "order" bill of lading as distinguished from the non-negotiable or "straight" bill. The latter is filled out in the name of a specified consignee, who may obtain the goods from the carrier without being under the necessity of producing the bill of lading.

This type, therefore, fails to safeguard the interests of the banker who has granted an advance on the goods, and so he prefers as collateral the order bill of lading, which represents absolute ownership over the shipment and which confers full title upon the holding party. The order bill of lading serves as collateral for advances in all commercial countries except several Latin American republics which prohibit its use.

NUMBER

As bills of lading thus serve several purposes, they are issued in sets of as many as eight copies, depending upon the requirements of the steamship company, the foreign consular office viséing them, and trade custom. The banker or any other party who has extended accommodation on a bill of lading should assure himself that he has in his possession all negotiable copies.

In negotiating documentary drafts, in handling particularly the accompanying bills of lading, the New York banks have agreed upon a set of rules, known as the "Regulations of the Commercial Credit Conference," which read as follows:

Regulations of the Commercial Credit Conference

- A. (1) Railroad export and forwarders' bills of lading will not be accepted.
- (2) Ocean bills of lading permitting transshipment will be accepted.
- B. (1) Bills of lading shall contain no words qualifying the

acceptance of shipments in apparent good order and condition.

- (2) "Received for shipment" or "alongside" bills of lading will be accepted and the date thereof taken to be the date of shipment, and in this case insurance shall cover the shipment from such date of shipment and on whatever vessels carried.
 - (3) When "on board" shipment is required and such shipment is represented by an "on board" bill of lading, the bill of lading date will be taken as the date when such shipment was effected; if evidenced by "on board" endorsement, the endorsement date will be so taken.
 - (4) Any extension of the date of shipment shall extend for an equal length of time the date for presentation or negotiation, and vice versa.
- C. The term "insurance" shall be construed as including underwriters' certificate of insurance.
 - D. A shipment for any part of the specified property may be drawn against if the pro rata value can be verified.
 - E. If shipment in instalments within stated periods is specified, and there is a failure to ship in any designated period, shipments of subsequent instalments, made in their respective designated periods, may be drawn against.
 - F. When the indicated expiration date for presentation or negotiation falls upon a Sunday or legal holiday, the expiration is extended to the next succeeding business day.
 - G. Presentation must be made during the usual banking hours.
 - H. The terms "prompt shipment," "shipment as soon as possible," "immediate shipment" or words of similar import shall be interpreted as requiring shipment to be effected within thirty days; and if no date for presentation or negotiation is stated, such presentation or negotiation must be made within thirty days from the date of the Credit or advice.
 - I. Documents representing more than the specified quantity of property may be accepted in the discretion of the

- paying or negotiating bank without thereby binding the buyer to accept or pay for such excesses but payment shall be limited to the sum named in the credit or advice.
- J. The terms "approximately," "about," or words of similar import, shall be construed to permit a variation of not exceeding ten per centum from the named sum or quantity.
- K. Drafts drawn without recourse will not be honored.
- L. Definitions of Export Quotations will be those adopted by the National Foreign Trade Council, Chamber of Commerce of the U. S. A., National Association of Manufacturers, American Manufacturers' Export Association, Philadelphia Commercial Museum, American Exporters and Importers Association, Chamber of Commerce of the State of New York, New York Produce Exchange and the Merchants' Association of New York at a conference held in India House, New York, on December 16, 1919.

AMERICAN LEGISLATION ON BILL OF LADING

While the bill of lading is a document defining the rights and liabilities of both shipper and carrier, the latter formulates the wording of this contract. He will naturally tend to frame the content of the instrument so as to relieve himself of liability as far as possible. This tendency has, however, been checked in some countries by legislative action preventing the carrier from discharging himself of his true responsibilities. The lead in this direction was taken by the United States in passing the Harter Act which has since served as a model for similar enactments by Japan and some of the British Colonies. Great Britain herself and most other

maritime countries have refrained from interfering with the carrier in his freedom of contract.

HAGUE RULES OF 1921

As each carrier issues his own bill of lading, there are about as many forms as there are shipping lines. This lack of uniformity has created considerable confusion and also much litigation among the various parties engaged in international trade. As a result, a movement was inaugurated in 1921, among business associations both in Europe and in the United States, to formulate a code defining the responsibilities and immunities of sea carriers. As the result of a series of conferences, there was finally evolved a set of regulations known as the "Hague Rules of 1921." The supporters of the Hague Rules had hoped to induce the more important steamship companies to embody the regulations as part of their ocean bills of lading, but such voluntary agreement proved difficult, because of the opposition of mercantile interests both here and abroad. There is now a disposition in several countries to make the principle of the Hague Rules effective by national legislation.

MARINE INSURANCE POLICY

An accepted principle of ocean transportation relieves the carrier of liability for loss of cargo from the accidental and unavoidable perils of the sea.

These risks must be borne by the shipper, but he can relieve himself of such hazards by transferring them to a marine insurance underwriter. Before the war, this business was largely in the hands of foreign companies, but the fluctuations in foreign currencies since 1914 have made the dollar a more desirable basis for payment, and American companies have entered the marine insurance field. The insuring company defines the risks and the extent of its obligations in a marine insurance policy which may be classified as either a blanket or an open policy. The former specifies the value of the goods, the name of the vessel, the extent of the voyage, and the period of the insurance. On the other hand, the open policy is indefinite in all these respects, and so facilitates the relations between insurance companies underwriting many risks and mercantile houses shipping goods continually and on a large scale. (For further readings on marine insurance, see Evans, H., *Relations of Insurance to Banking and Shipping*; Gow, W., *Marine Insurance*; Huebner, S. S., *Marine Insurance*; Winter, W. D., *Marine Insurance*.)

INSURANCE CERTIFICATE

Under open-policy arrangements, it has become customary, especially in the American export business, not to issue a complete policy, but merely a certificate, which contains a detailed description of

Because of this incompleteness, the British Court of Kings Bench in *Diamond Alkali Export Corporation vs. Bourgeois* (III Law Reports, 1921, Kings Bench, 443) held that a certificate of insurance was not an acceptable document when the sales contract between the buyer and the seller definitely called for a marine insurance policy (see also *Scott vs. Barclays Bank*, 92 Law Journal, 1923, Kings Bench, 772).

COMMERCIAL INVOICE

The exporter thus finds his relations with the carrier defined in the bill of lading, with the underwriter in the marine insurance policy, and finally with the consignee in the commercial invoice. This instrument contains complete data concerning the price, quality, quantity, and description of the shipment. It also includes a statement of the export price quotation, which may be any of the following:

F.O.B. Free on board.

F.A.S. Free along side.

C. & F. Cost and freight.

C.I.F. Cost, insurance, and freight.

L.C.L. Less than carload lot.

MINOR DOCUMENTS

While the bill of lading, the marine insurance policy, and the commercial invoice, constitute the major documents in the commercial set, it may also include a number of miscellaneous certificates

required to insure the shipper against interference by the government. These may consist of the consular

INVOICE NO. _____

John Doe & Co.,
London, England.

NEW YORK, October 17th, 1923.

ON ACCOUNT **ALBERT C. FIELD, INC.**
WITH GRAIN MERCHANTS

C-22 PRODUCE EXCHANGES

CONTRACT OF October 17th, 1923.

QUANTITY	PARTICULARS		TOTAL
1000 Qtrs.	8,000 Bus. #2 Hard Winter Wheat	42/- per Qtr. CIP	£2150-0-0
	Less freight @ 2/6 per Qtr.		100-0-0
	" London Clause 7d. per Ton		£2050-0-0
			6-6-0
			£2043-15-0
	S:8 J. SMITH, New York to London		
	B/L Dated October 17th, 1923.		
	Moved in hold 1		
	Documents attached:		
	1 Bills of Lading in duplicate		
	1 Insurance Certificate		
	1 Inspection Certificate		
	1 Weight		

B. & G. E.

ILLUSTRATION 9
Commercial Invoice

invoice, export declaration, certificate of origin, non-dumping certificate, and inspection certificate.

The inspection of agricultural exports from the United States is described as follows:

Grain. Grain shipments are inspected in New York by the New York Produce Exchange and in other ports by similar organizations. The inspection is made in conformity with standardized grades that have been established by the United States Department of Agriculture, and such inspection is more or less under the supervision of this department. Certificates

EXPORT INSPECTION
GRAIN INSPECTION CERTIFICATE
NEW YORK PRODUCE EXCHANGE
NEW YORK CITY, N.Y.

CANCELLED

NOV 1 1923
OCTOBER 17, 1923

I Hereby Certify that I hold a license under the United States grain standards Act to inspect and grade the kind of grain covered by this certificate, that on the above date I inspected and graded the following lot or lots of grain, and that the grade thereof, according to the official grain standards of the United States, is that stated below.

Vessel S/S JOHN SMITH Hatch No. ONE

Amount 8000.0/60 Kind No. 2 Grade HARD WINTER WHEAT

Countersigned
Laurence A. Lusk
CHIEF INSPECTOR

Account of _____ by _____
LICENSED INSPECTOR

CANCELLED

ILLUSTRATION 10

Inspection Certificate

of quality are issued specifying the grade, kind, and condition of the grain. Weight certificates are issued by the elevator which delivers the grain to the steamer.

Rice. Rice is inspected at the Gulf ports by various organizations, notably the Rice Millers Association and the local boards of commerce. Samples are drawn from export shipments at the dock and passed upon by an appointed committee. Certificates are issued which show the grade, kind, and condition of the rice. The rice is also tested for moisture content and the percentage noted upon the certificate. A standard system of

grades is maintained, but these grades are relative rather than constant, depending more or less upon the crop average and thus varying somewhat from year to year.

Coal. Coal is inspected at the coal ports by the Tidewater Exchange. This exchange controls the pooling of the coal according to its quality or grade and the district from which it comes. When delivery is made to steamer the Tidewater Exchange issues a certificate denoting the pool from which delivery is made. Certification is also made as to weight.

Meats and Provisions. The Bureau of Animal Industry issues a certificate covering meats and provisions. This is merely a health certificate and does not in any way denote the actual quality, grade, or merchantable value of the product. Such certificates are required by the government on all export shipments, the steamer not being permitted to carry such products until certificates are produced. The Board of Trade in Chicago and other packing house cities issue certificates covering grade and quality, inspection being made in the packing house. The New York Produce Exchange appoints private concerns as official inspectors for the performance of such services when goods arrive in New York.

Cotton. Ample provision is made for the inspection and grading of cotton in the South Atlantic and Gulf ports. The New Orleans Cotton Exchange is a notable example. Elaborate and comprehensive regulations have been established by this exchange for scientific grading and classification of cotton shipments and for transportation, storage, and weighing, all of which is conducted under careful supervision. These standards and grades are made to conform with the regulations of the United States Department of Agriculture. Certificates are issued covering grade, conditions, and weight.

WAREHOUSE RECEIPTS — MEANING AND CONTENTS

It is often necessary to store commodities in warehouses at various stages in the marketing. The

warehousing system has been especially well developed in countries such as the United States and Canada, which export wheat, corn, fruit, wool, and other staple agricultural products. These can be graded and classified according to definite standards, and in the case of fungibles of the same grade, such as wheat, they can be mixed indiscriminately in grain elevators. Receipts can then be issued covering, not a specified lot, but simply a certain quantity of a particular grade. Commodities thus deposited in warehouses may well serve as collateral for loans, and so the warehousing industry and the banking business stand in close relation to each other. The warehouseman, on receiving property for storage, acknowledges it in a document known as a warehouse receipt. It is a written guarantee of the warehouseman that he is holding in trust certain goods which he will deliver on demand. This receipt should, therefore, contain the following data:

- (a) The location of the warehouse where the goods are stored.
- (b) The date of issue of the receipt.
- (c) The consecutive number of the receipt.
- (d) A statement whether the goods received will be delivered to the bearer, to a specified person, or to a specified person or his order.
- (e) The rate of storage charges.
- (f) A description of the goods or of the packages containing them.
- (g) The signature of the warehouseman or of his authorized agent.
- (h) If the receipt is issued for goods of which the warehouse-

man is owner, either solely or jointly or in common with others, the fact of such ownership, and

- (i) A statement of the amount of advances made and of liabilities incurred for which the warehouseman claims a lien. If the precise amount of such advances made or of such liabilities incurred is, at the time of the issue of the receipt, unknown to the warehouseman or to his agent who issues it, a statement of the fact that advances have been made or liabilities incurred and the purpose thereof is sufficient.

(*Warehouse Receipts as Collateral*, p. 1, issued by the American Warehousemen's Association.)

NEGOTIABILITY

A warehouse receipt includes not only an acknowledgment of the deposit of goods but also a promise on the part of the warehouseman that he will make delivery on demand to a designated person only, or to his order, or to any holder, depending upon whether the receipt is non-negotiable or negotiable in form. As early as 1850, the United States Supreme Court held that the delivery of a warehouse receipt as collateral for a loan serves as a transfer of the goods themselves, which then actually become the property of the transferee.

Both negotiable and non-negotiable forms may be used as collateral documents. The negotiable receipt is filled out to the order of a specified party, who can then transfer his rights of possession by endorsement in favor of the banker or any other party who has granted the loan. The lender may also obtain a

non-negotiable receipt written in his own name, and thus the goods are under his sole control and are so recorded on the books of the warehouseman. Only a written order from the banker will permit the warehouseman to deliver the goods to another party. (For negotiability of warehouse receipts, particularly in connection with loans on cotton, see digest of warehouse laws in *Federal Reserve Bulletin*, Vol. I, pp. 260-2.)

PROTECTION OF RECEIPTS

The granting of loans on warehoused commodities involves a variety of risks. These relate both to the commodity and to the warehouse. The banker must ever be watchful of the market and the forces of supply and demand for the commodity. A collapse in the price and a consequent decline in the value of the collateral may, to a certain extent, be anticipated by arbitrarily valuing the commodity at a lower figure than its current market price and then by requiring further margin of twenty or thirty per cent or even more. However, the banker must also protect himself against improper warehousing, which may directly affect the quality and hence the marketability of the collateral. As the banker may at any time become the actual owner of the commodity, he is interested in seeing that it is fully safeguarded against deterioration from exposure to fire or water, or loss through fraud on the part of the warehouseman. The extent of these risks depends

upon the condition of the warehouse and the reliability of the warehouseman, factors which vary considerably. Banks generally have lists of warehouses whose receipts they accept, while produce exchanges and similar bodies approve certain warehouses whose receipts constitute a "regular" delivery on the exchange.

In order to effect greater standardization in warehousing facilities and to augment the acceptability of receipts as collateral documents, banking and business organizations have obtained the passage of legislation in this field of activity. For many years the legal codes of most states contained general warehousing laws based largely on the old common law of England. In 1906, a Uniform Warehouse Receipt Act was drafted by the Commissioners on Uniform State Laws and this has since been passed by all but four states. Such uniformity was highly desirable because of the vast interstate business in wheat, tobacco, cotton, and other staples. Another step later has been in the direction of more standardized receipts. In 1917, the American Bankers' Association and the American Warehousemen's Association devised a negotiable and a non-negotiable form.

UNITED STATES WAREHOUSE ACT

Because of the need of uniformity in interstate business, Congress passed the United States Ware-

house Act, which became law in 1916. The purpose of the Act is to effect closer relations between the producers of commodities and the grantors of credit and to facilitate the financing of agricultural products in storage, by standardizing the conditions of storage and so developing a warehouse receipt acceptable as collateral.

The secretary of agriculture, under the statute, is empowered to license warehousemen who possess a specified minimum net worth, and who agree to store products in accordance with the conditions as established by the Bureau of Markets. After filing an application, the warehouseman's credit standing is investigated and his warehousing facilities are examined. If he meets the requirements, and files a bond ranging from \$5,000 to \$50,000 depending upon his net worth and storage facilities, he is given a license. Thereafter his warehouse is periodically inspected, and besides, he must keep careful record of all his transactions.

Although in operation only a few years, the act has resulted in making the holder more certain of the validity of the warehouse receipt and rendering it more suitable as collateral for credit extensions. (See publications of the United States Department of Agriculture, *Service and Regulatory Announcements*, No. 61, 71, *Cotton Warehouses*, No. 216; *Cotton Warehousing*, No. 763; *Regulations for Grain, Cotton, Tobacco, Wool Warehouses*.)

Since the passage of the act it has received minor amendments which have made only slight changes in its operation. In February, 1923, the act was broadened so as to permit the secretary of agriculture to extend the licensing system to the warehousing of any commodity which he regards as suitable for collateral.

TRUST RECEIPT — NATURE ¹

In this chapter, shipping documents and warehouse receipts have been viewed as forms of collateral for advances extended by bankers to business houses. Both parties are interested in a rapid movement of the goods to market and in a consequent prompt liquidation of the entire transaction. The actual marketing of the goods is a task for the merchant, rather than for the banker. Although the latter, by granting a loan on the shipment, has really become the owner, it is necessary for him to permit the merchant to have physical possession of the goods at certain stages in the marketing by giving him either the shipping documents or the warehouse receipts. In so doing, the banker usually requires the merchant to sign a document known as a trust receipt, whereby the merchant, as trustee, receives possession of the goods, but at the same time acknowledges that they are the property of the

¹ For fuller discussion see the author's *Foreign Commercial Credits*, Ch. IX.

banker as owner and promises that these property rights shall remain unimpaired.

The purpose of the trust receipt is thus to protect the rights of the creditor banker who has parted with certain goods to the debtor merchant who must handle the goods in accord with a specific purpose. In England, this instrument is known as a "trust letter," or "letter in lien." In the Far East a bank which grants a loan to an exporter on a trust receipt covering goods stored in a warehouse and awaiting shipment is said to extend a "packing" credit.

USE

The trust receipt may be employed at one or more of the successive stages in the importation of goods from abroad. When a bank grants an advance to a business house on an importation, the shipping documents are generally sent to the former, which is actually the owner until the latter has liquidated the loan. The bank, however, will release the shipping documents to him in order to enter the goods at the custom house and then place them in a warehouse. The warehouse receipts must be promptly surrendered to the bank, which may again release these documents for the purpose of enabling the importer to sell the goods, to manufacture them into a finished form, or to re-ship them either by rail or steamer. In thus releasing the goods into the hands of the customer even though he has signed a

Trust Receipt Commercial Credits Division

New York City, February 10, 19 24

Received from the GUARANTY TRUST COMPANY OF NEW YORK, for one of the following purposes, as indicated by (x).

- ☐ 1. For Export Shipment.
☐ 2. For Warehousing.
☐ 3. To Exchange for Domestic Order Bills of Lading (Railroad or Steamship).
☐ 4. For immediate delivery to _____ who have/has purchased the same for \$ _____ payable _____ and to obtain from the purchaser the proceeds of the sale.
☒ 5. For delivery to various buyers

the goods and merchandise specified in the documents described below, both such documents and said goods and merchandise belonging to and being the property of the said Trust Company, and in consideration thereof I/we hereby agree to hold said goods and merchandise in trust for it and as its property and to deliver over to the said Trust Company or its assigns, immediately upon the receipt thereof by me/us, and in any event not later than (Date) February 28 any one of the following representing the goods and merchandise described below according to the purpose for which the original documents are withdrawn:

1. Complete Set of Order Ocean Bills of Lading.
2. Negotiable Warehouse Receipts of Independent Warehouse, Inc., or other warehouses satisfactory to said Trust Company.
3. Domestic Order Bills of Lading. (Railroad or Steamship.)
4. Proceeds of the sale of such goods or merchandise, it being understood that immediately upon receipt by me/us of such proceeds the same shall be delivered to the said Trust Company in whatever form collected and whether or not my/our obligation to it shall have matured. It is understood that such proceeds are to be applied by said Trust Company against my/our indebtedness to said Trust Company, whether due or to become due. However, if such proceeds be in notes, bills receivable or acceptances, they shall not be so applied until paid, but held until maturity by said Trust Company, with liberty meanwhile to sell or discount and so apply the net proceeds.
- 5.

The delivery herein is temporarily made to me/us for convenience only, without novation, or without giving me/us any title to the documents or the goods and merchandise they represent, except as trustee and agent for the said Trust Company for the purposes herein indicated.

Said Trust Company may at any time cancel this trust and take possession of said goods and merchandise or any of said documents or of the proceeds of the same wherever said goods and merchandise and documents or the proceeds thereof may then be found or located, and in the event of suspension, proceedings in bankruptcy or assignment for the benefit of creditors on my/our part or of the non-fulfillment of any obligation or of the non-payment at maturity of any indebtedness on my/our part to said Trust Company, then in any such case, all obligations, acceptances, indebtedness and liabilities whatsoever shall forthwith mature and become due and payable.

The said goods and merchandise shall at all times at my/our expense, be fully insured against loss by fire and any other risk that said goods and merchandise may be subject to. The insurance policies or certificates of acceptable companies in proper form showing loss, if any, payable to the GUARANTY TRUST COMPANY OF NEW YORK, will be deposited with it on demand.

The undersigned in further assurance, agree that insofar as the undersigned may make entries or records of transactions herein set forth or provided for in the books of account of the undersigned, such entries shall definitely indicate that said merchandise and documents and the proceeds thereof are the property of said Trust Company.

Receipt of a copy of this Trust Receipt is herewith acknowledged.

DESCRIPTION OF DOCUMENT	QUANTITY	GOODS AND MERCHANDISE. (GIVE MARKS AND NUMBERS)	VALUE
<u>2 Bills of Lading</u>	<u>1000 bags</u>	<u>Coffee J. W. Co. B-1/8</u>	<u>\$16,823</u>
<u>1 Consular Invoice</u>			
<u>1 Commercial Invoice</u>		<u>Under L/C No. 890624</u>	

Signed James Williams & Co.

ILLUSTRATION 12

Trust Receipt

trust receipt, certain risks are taken by the bank. It loses physical control over the goods, which often cannot be identified when converted into a manufactured form. There is also the possibility that the proceeds derived from the sale of the goods will be retained by the customer instead of being surrendered to the bank. To prevent such contingencies, the bank may adopt the following policies:

- (a) Select the warehouse.
- (b) Store goods in the name of the bank.
- (c) Approve of the purchaser of the goods.
- (d) Demand the substitution of other goods for those withdrawn from the warehouse for the purpose of manufacture.

The right to insist upon such actions is contained in the trust receipt of which a typical form is presented above.

THE TRUST RECEIPT IN LAW

Numerous cases have arisen out of the relations of parties under a trust receipt. This instrument involves primarily a banker as creditor and his customer as debtor on account of a loan collateralized by certain merchandise. The debtor on receiving these goods may sell them to a third party, who may be unaware of the claim of the bank. The question therefore arises, is a superior right to the goods held by the banker who has granted a loan on them as

collateral, or the purchaser who has bought them in good faith? Legal complications over the trust receipt have developed mainly from bankruptcy cases which have been tried before the federal courts. Until recently the courts have upheld the rights of the lending bank under the trust receipt on the ground that it was a necessary instrument of commerce. However, in 1922, the Circuit Court of Appeals rendered decisions adverse to the lending banks (*re A. E. Fountain Inc. and re Dernburg & Sons Inc.*, 282 Fed. 816). The reasoning of the court may be traced from the following excerpts:

In essential respects the legal status of the person financing these operations resembles that of a mortgagee. The original vendor is the mortgagor, who has conveyed his title as security for the debt of the buyer. He also conveys his equity to the buyer of the merchandise. But the buyer has never held the legal title and will not obtain it until and unless he pays his debt.

. . . Any such extension of the rights of the holders of trust receipts as is sought to be established here would, if consistently applied, enable every money lender, by employing a trust receipt, to preserve a secret lien, and would virtually destroy the efficacy of the Chattel Mortgage Act. We regard the contention as untenable and unsupported by authority. The only cases where the holders of trust receipts have been allowed by this court to prevail against the ultimate purchaser or his trustee in bankruptcy, have been those where the title of the holder of the trust receipt was derived from some one other than the debtor.

. . . The result of the foregoing is that the holder of a trust receipt has no better standing than the holder of an unfilled chattel mortgage, unless he derives his security title from a person other than the one responsible for the satisfaction of

the obligation which the property secures. In such a case only can he deliver the property to the obligor to act as his fiduciary.

In a careful review of the state and federal decisions on trust receipts, Mr. Karl Frederick, member of the New York Bar, came to the following conclusions:¹

(1) The only situation in which a trust receipt may properly be used is one in which the title of property by way of security is conveyed to the creditor by an owner who is not the person responsible for the satisfaction of the obligation which the property secures but where such obligor has a contractual or beneficial interest in the property subject to the satisfaction of such obligation. The creditor may then deliver the property to the obligor who has hitherto had neither title thereto nor possession thereof, against an appropriate trust receipt. The rights of the creditor in the property will be protected to the extent of the special trust receipt doctrine. In practice, the trust receipt situation exists only in connection with advances for the purchase of goods by way of the payment of drafts against bill of lading.

(2) The trust receipt should never be used in connection with the redelivery of property pledged or mortgaged by the person signing the trust receipt.

(3) In the proper trust receipt situation, the creditor generally a bank or banker, has legal title to the property for the purpose of security. This creditor is a mortgagee and the arrangement is a chattel mortgage, but of a peculiar type, distinguishable from the usual chattel mortgage by reason of the fact that the obligor has not prior to the arrangement had either title to or possession of the property mortgaged.

(4) Except in Ohio, Illinois, and perhaps South Carolina and Virginia, cases so far decided hold that the trust receipt

¹*Columbia Law Review*, May and June, 1922.

does not come within the provisions of the recording acts respecting chattel mortgages or conditional sales.

(5) In New York and Massachusetts, where the factors' act is in force, a bona fide mortgagee or pledgee for present value obtains from the signer of the trust receipt a right superior to the title of the creditor who holds the trust receipt.

(6) The adoption of the Uniform Bills of Lading Act and the Warehouse Receipts Act by various states has given to those instruments in large degree the qualities of negotiable instruments. These laws accomplish the results of the factors' act. In those states which have adopted the definition of "value" as recommended by the Committee on Uniform Legislation, an antecedent debt constitutes value, and a bona fide purchaser, pledgee or mortgagee of such a document, regular on its face and from one to whom it has been entrusted by the holder of the trust receipt, obtains a title superior to the rights of the holder of the trust receipt.

(7) If goods themselves are entrusted under trust receipt, appropriate language should be used to negative any presumption of right in the signer to take negotiable warehouse receipts to his own order.

(8) Except as noted in (4), property delivered to the signer of a trust receipt under circumstances suitable for the use of such an instrument may, if identified, be retaken from the signer at any time before the satisfaction of the obligation secured by the property. It may also be retaken from his receiver, assignee, trustee in bankruptcy or an attaching creditor. Its proceeds may likewise be retaken, provided they can be identified.

(9) The unpaid purchase price of property delivered to the signer against his trust receipt and by him sold to a bona fide purchaser may be recovered by the holder of the trust receipt directly from such buyer.

(10) The property delivered in a proper case against trust receipt may be recovered by the holder of the trust receipt, prior to payment of the obligation secured thereby, from any person to whom the signer has delivered the same, unless such

right of recovery is cut off by the exercise of a power of sale, express or implied, or statutory provisions which include a bona fide pledge or mortgage within the scope of such power.

(11) The trust receipt cannot assure to the holder thereof any rights beyond those which he would have had as the holder of an unrecorded chattel mortgage, an equitable pledge or mortgage, or a simple contract, if it is used in any case other than that which has been defined as a proper trust receipt case.

(12) The benefit of the trust receipt doctrine is not dependent upon any special virtue in the name or the precise form or appearance of the agreement. If the agreement can in substance be shown to have been clearly made between the parties in a proper case, the legal results will follow, even though resort is had to the original credit agreement for the purpose of establishing the existence of the security arrangement.

TRUST RECEIPT IN ENGLAND

The trust receipt has been employed in England for many years, but its use has become extensive only since the close of the war. In general, British banks follow more cautious policies in connection with their trust receipts than do American institutions. The former rarely permit the release of goods for the purpose of manufacture, and if yielded to an importer for the purpose of effecting a sale, the proceeds must be surrendered to the bank within a few days, whereas American banks often allow several months to elapse before insisting upon settlement. British banks also refrain from financing goods shipped in consignment which may entail warehousing over a considerable period of time. British banks, as a rule, employ instruments which

are simple in form, and a typical trust receipt, notable for its brevity in contrast to American documents, reads as follows:

BANK OF LONDON.

GENTLEMEN,

We have to acknowledge receipt of your letter of the.....
.....19.....handing us the documents mentioned in the schedule hereunder written.

We receive the documents of title to the goods specified in trust on your account, and we agree to hold the goods when received and their proceeds when realized, as your trustees, and to remit you the entire amount of the payment, together with all expenses, within.....days from the date hereof. We undertake to give you on request full authority to receive from any person or persons the purchase-moneys of such goods or any of them; we also undertake to keep the goods fully covered by insurance against fire and to hold policies on your behalf.

Yours faithfully,

TRUST RECEIPT IN BRITISH LAW

The rights of banks under receipts have been fully recognized in British Law (*Hamilton Young vs. Ex parte Carter* 1905, B. 772, *Northwestern Bank Ltd. vs. John Payston, Son vs. MacDonalds* 189 A. C. 56).

About the same time that the federal courts in the United States were limiting the rights of banks under trust receipts, British courts were extending them. Through a far-reaching decision rendered in *David Allester Ltd.* (1922, 2 Ch. 211), because of its

significance in upholding the rights of banks under trust receipts, an analysis of this leading case is of interest. The David Allester Company had received a loan from Barclays Bank on the strength of certain shipping documents. These were later released by the bank to the company on its signing the usual trust receipt stating that the goods were to be sold and the proceeds remitted to the bank. These conditions were not observed by the company, which, furthermore, went into liquidation. The bank sought to recover the property and offered expert evidence that:

“the custom or practice whereby goods pledged with a bank were released for a purpose of sale under a letter of trust was very well known and generally adopted and made use of in banking business. It had been in existence for twenty years and upwards and during that period the letter of trust had always been considered and treated as being a document used in the ordinary course of business, as proof of the possession or control of goods, and accordingly excepted from the operation of the Bills of Sale Act, and an enormous number of transactions had been carried out by the bank on that basis” (p. 213).

This contention of the bank was upheld by the court, which defined trust receipts as

“records of trust authorities given by the bank and accepted by the company stating the terms on which the pledgors [the company] were authorized to realize the goods on the pledgee’s behalf, [the bank].”

The court further added that,

“letters of trust really create no mortgage or charge or book debts in any true sense of the word at all. The bank had its charge

before these letters came into existence. The object of these letters of trust was not to give the bank a charge at all, but to enable the bank to realize the goods over which it had a charge in the way in which goods in similar cases have for years and years been realized in the city and elsewhere."

The importance of the ruling was fully understood by Lombard Street and the feeling was expressed by the *Financial News*, June 22, 1922, in the following comment:

"This decision has been very much appreciated in banking circles as the trust letter is very extensively used. Had the decision been given against the bank a very convenient method of handling large numbers of transactions would have been in jeopardy and more cumbrous methods of safeguarding the banker's position would have had to be devised to the annoyance of both banker and trader alike."

In the above decision, it will be noted that, while the court supports the rights of the bank on purely legal grounds, it does not hesitate further to defend the position of the bank on the basis of commercial usage. On this point, American and British courts differ, for the former generally refuse to uphold the views of the banks in such issues, while the latter uniformly support the contentions of the financial institutions. This tendency is quite apparent in the decisions rendered during the past century when London was establishing itself as the international banking center for financing the world's trade.

TRUST RECEIPTS IN OTHER COUNTRIES

The trust receipt finds little employment in other countries. Japanese banks release goods on trust receipts only to firms of the highest credit standing, and then only for storage, not for selling or for manufacturing. Its use is restricted on the Continent where it is not generally recognized in law, and so it is inadvisable for American exporters to release goods to foreign importers on trust receipts. While the American exporter would be able to recover his goods from the importer if he became insolvent, they could not be reclaimed from third parties who in good faith had purchased them.

THE WARRANT

In place of a trust receipt, these countries make use of an instrument known as the "warrant." A form as used in Holland translated reads as illustrated on page 286.

This is really a duplicate warehouse receipt, or rather a combined warehouse and trust receipt. The warehouse receipt, as a single certificate evidencing title to goods in storage, is used in the United States and in Germany. Most of the continental countries employ duplicate documents, one known as a "cédule" or a "récepissé" (receipt) and the other as a warrant or "bulletin." The former serves to transfer property rights in case of a sale, and the latter is used as the basis for a loan.

 THE HOLDER IS ENTITLED TO RECEIVE

No.....

forBales
 weighing gross.....Kilograms, tare.....
 Insured against risks of fire, at the market-value of the day,
 under the conditions filed on the day of, 192....
 at the Court of this City, under right of alteration, pro-
 vided it does not take effect earlier than after notice in two
 Amsterdam newspapers.

Amsterdam,192

Marks etc.

Storagecents per month perKg. Storage,
 charges and policy-stamp duties to be paid when
 taking delivery of the goods, for within a year after
 to-day, in default of payment the company will be
 entitled, after having put two unanswered summons in
 one of the newspapers issued in Amsterdam, to sell the
 goods in order to obtain cover for storage and charges.

The storage company does not assume any re-
 sponsibility for fire, except the lien of the holder of the
 warrant on the indemnity, received by the company
 from underwriters, less three and a half per cent for
 its trouble, charges and commission.

ILLUSTRATION 13

Warrant

The use of the combined *cédule* and warrant enables a continental merchant to store his goods, and on this collateral at the same time to obtain a loan. The warehouseman gives the merchant the combined *cédule* and warrant describing the quantity and the quality of the goods. Both instruments being filled out to order are freely negotiable, and so, when the merchant seeks a loan, he merely detaches the warrant and gives it to his banker.

All the facts concerning the loan are recorded on the *cédule*, which is retained by the merchant. He can show this certificate when offering the goods to prospective buyers, but he is no longer able to withdraw the goods from the warehouse without first getting back the warrant from the lending bank. It is thus evident that while the *cédule* gives the merchant possession of the goods, the banker retains full ownership so long as he holds the warrant.

The use of the warrant has certain advantages both to the merchant and to the banker. The former is able to show his customer a certificate evidencing the storage of certain goods which he can sell more readily than is the case when the warehouse receipt is retained by the bank. The warrant is also helpful to the banker, for through it he practically retains all the rights conferred upon him by the terms of a trust receipt. Under either instrument he is to be empowered to sell the goods in the event that the borrower fails to meet his obligations. In addition, the warrant recognizes the banker as unqualified owner, and so unquestionably as a privileged creditor. In most European countries a warrant partakes of the nature of commercial paper and may be rediscounted with the central bank.

The rights of third parties are also protected by the warrant. As mentioned above, the instrument contains a statement of the banker's loan, and hence serves general notice to all persons of the

existence of a prior lien upon the warehouse goods. Thus the warrant overcomes the main defect of the trust receipt system, which fails to inform innocent third parties who purchase the merchandise in good faith that it has already been subject to the prior claim of a lending bank.

CHAPTER XI

TRADE FINANCING BY THE EXPORTER

At this point, it may be well to stop for a moment and review the general treatment of the subjects under consideration. Part II of the book presents an analysis of the principles of commercial financing or the extension of short-time credit to facilitate the movement of goods in international trade. In Chapter VII attention was directed to the credit relation between buyer and seller and the formulation of an intelligent commercial credit policy; in Chapter VIII to the sources of credit information as a basis of extending unsecured credit; in Chapter IX to credit insurance as a protection against credit losses, and in Chapter X to documents of collateral as security for advances in international trade. These subjects were considered largely from the viewpoint of the exporter and importer and little or no attention has so far been paid to the banker. His function in foreign trade will form the subject of analysis in the remaining chapters of Part II.

METHODS OF TRADE FINANCING

Chapter VII discussed the various forms of sales terms, namely, cash payment, open account, and draft settlement, and showed the conditions whereby

the credit burden is shifted either upon the importer or the exporter. The next two chapters will trace the technical methods whereby these ends are accomplished. These methods may be summarized as follows:

Methods of financing foreign trade:

I. By the exporter or his bank.

1. collection.

a. straight.

b. advance.

c. refinancing.

2. cash.

a. draft.

b. letter of delegation.

II. By the importer or his bank.

1. letter of credit.

2. authority to purchase.

3. bank guaranty.

The next chapter will discuss the methods of trade financing by the importer and his bank, and in the present chapter consideration will be confined to the methods of trade financing by the exporter and his bank.

DISTINCTION BETWEEN COLLECTION AND CASH ITEMS

These methods may be classified as "collection" or "cash," to borrow expressions used in domestic banking. In this field all instruments, whether

checks, notes, drafts or coupons, are grouped as either collection or cash items, depending upon whether the depositor receives credit to his account after or before the bank itself obtains the funds. Thus in the case of a collection item, credit is deferred until the actual payment of the instrument, while a cash item gives the depositor immediate credit against which he can draw and obtain the proceeds at the same time that he gives the item to his bank.

These observations apply to foreign items with but little amendment. An exporter, after drawing his draft upon the importer or the latter's bank, may place this bill with his own bank either for collection or for discount and so it is either a collection or a cash item. In the former case, the exporter prefers to wait until the draft is paid when he receives the full amount, and in the latter instance he desires immediate funds which are less the face amount of the draft because of the discount deducted by the bank. This discount represents the interest which the bank charges for the privilege of giving the importer funds in the present as against payment in the future.

Thus when a draft covering a shipment of goods is sent for collection, this method places the financial burden of carrying the transaction upon the importer, and the bank then acts merely as collecting agent, whereas the discounting of the item throws the burden upon the bank.

REASONS FOR PLACING ITEMS EITHER FOR DISCOUNT
OR COLLECTION

Whether an item is placed by an exporter with his bank for discount or for collection depends upon the attitude of both parties. If the exporter feels that his cash position is sufficiently strong, he will prefer to save the interest charge and so will lodge his draft for collection; on the other hand, if he does not wish to tie up his working capital, he will seek immediate cash and so will ask his bank to discount the item. The bank on the other hand discounts a draft only if the credit standing of the drawer and drawee is satisfactory and the ability to make payment is thus reasonably assured. The currency of the draft will also influence the bank in taking it for discount or for collection. Foreign currency drafts drawn in countries with depreciating money standards are taken only for collection, while bills payable in stable currencies may more readily be discounted.

NATURE OF A DISCOUNT ITEM

When a bank discounts a draft the procedure is often described as buying the draft. There is, however, a legal distinction between discounting a bill and buying any other commodity. In purchasing a good in the ordinary way, the buyer becomes the owner and according to the principle of *caveat emptor* (let the buyer beware), he cannot

well demand restitution from the seller if the quality proves unsatisfactory. But a bill of exchange because of its negotiable character gives the holder full recourse or claim upon all previous holders or owners. So if the drawee fails to honor the bill, the discounting bank may obtain reimbursement from the drawer. Hence the act of discounting is not so much like buying a bill but rather like granting a loan of 100 per cent to the exporter on the draft as security. The exporter cannot therefore consider himself uninterested in the fate of a discounted bill, for it remains a contingent liability which may become actual if payment by the drawee is not forthcoming. True, he may draw the bill "without recourse," but banks are unwilling to discount drafts so qualified. While there is no question about the recourse of the discounting bank, to the drawer in American law, there is a difference of opinion in this point among British authorities. Stead, in *Bankers' Advances*, page 8, writes:

"When a banker discounts a bill the property in the bill passes, but there is a right of recourse against the customer under his indorsement."

On the other hand, no less a jurist than Sir John Paget says:

"I have always doubted whether a banker has any recourse against his customer on a bill or cheque he has discounted or taken for value except on the indorsement or by special agreement." (But see Gordon case, 1903, A.C. p. 248.)

COLLECTION ITEMS

While discount items are all in one form, there are three distinct kinds of collection bills. The type so far described has been the straight collection item, which the exporter owns solely and which yields him the full amount at maturity. There is a second form in which the exporter and the bank are jointly interested. This form, known as an "advance collection," arises when the banker extends a loan to a certain proportion, say 60 or 80 per cent, of the face amount of the bill. This procedure is in a way a partial rather than a full discount.

The percentage of the advance granted by banks is determined largely by the marketability of the underlying shipment. In the case of such non-perishable foodstuffs as grains or storable raw materials as cotton, a more liberal advance is allowed than on finished goods of limited marketability.

The third type is somewhat more complicated. The exporter lodges his documented draft with his bank which forwards it for collection, and at the same time the bank permits the exporter to draw a clean time draft upon itself. This instrument when accepted becomes a bankers acceptance or "re-financing" acceptance which can be discounted in the open market and thus yields immediate funds to the exporter. When the documented draft is

later paid by the drawee, these proceeds can then be used by the bank to meet its own bill at maturity.

The exporter has the choice of placing his collection items directly with a bank in the country of the drawee or indirectly with an American bank operating a foreign department. It is generally unwise to send drafts directly to foreign banks, for they will not give the same attention to these as is given to drafts forwarded through American financial institutions. True, the collection charge of the latter is thus saved, but competition among banks has reduced this fee so that it is little more than the cost of handling the item. As a matter of fact, many American banks operate their foreign collection departments rather as a service for their customers than for a profit to themselves.

ENDORSEMENT

The exporter may endorse drafts forwarded for collection in either of the following ways:

“pay to the order of the X Bank”

“pay to the order of myself.”

As a rule the former endorsement is employed when bills are given to the bank for discount and the latter form is used on drafts placed for collection.

DOCUMENTS — LETTER OF INSTRUCTION

Once the drafts are endorsed by the exporter and lodged with the collecting bank, the procedure of

collection is a matter of technical banking practice which can best be understood by examining the documents employed in these operations.¹

COLLECTION DOCUMENTS

The forwarding of an item for collection, whether domestic or foreign, involves such parties as drawer, sending bank, presenting bank, and drawee. The relation between drawer and sending bank is expressed in the "letter of instruction," while the relation between the sending and the presenting bank is stated in the "letter of advice," or, as it is more generally termed, "remittance letter."

DEAR SIRs: We enclose for $\frac{\text{discount}}{\text{collection}}$ the undermentioned draft with documents as enumerated. The surrender of documents to drawee is conditional upon fulfillment of instructions as indicated by cross (X) in margin.

	DRAFT	NUMBER	DOCUMENTS
No.....	Commercial invoice
Drawer.....	Consular invoice
Drawee.....	Bills of lading
City where payable...	Insurance certificate
Date.....	Certificate of origin
Amount...	Weight certificate
Drawn at.....	Declaration of shipper

¹ The following part of the chapter has been adapted from a study of foreign collections conducted by the author for the Federal Reserve Board and published in the *Federal Reserve Bulletin*, May, 1922, pp. 522-528.

INSTRUCTIONS

Documents against $\frac{\text{payment.}}{\text{acceptance.}}$

Protest for $\frac{\text{nonpayment.}}{\text{nonacceptance.}}$

Permit drawee privilege of inspecting merchandise before accepting draft.

Hold for arrival of goods.

Payable at collecting bank's selling $\frac{\text{check}}{\text{cable}}$ rate on New York day of payment.

Payable at check rate on New York, remitting proceeds by cable, charges for our account.

Interest to be collected at ——— per cent from date of issue until approximate arrival cover in New York.

Allow drawee interest at ——— per cent per annum for anticipated payment.

All charges are for account of $\frac{\text{drawer.}}{\text{drawee.}}$

Waive charges if refused by drawee.

In case of need refer to ——— and advise immediately by mail.
cable.

Yours truly,

ILLUSTRATION 14

Letter of Instruction

The letter of instruction is a form usually furnished by the bank, but large exporting houses at times prefer to use their own blanks. The instrument states the conditions to be observed by the bank in handling the transaction. While the bank

is thus bound by these terms, at the same time it cannot be held responsible for contingencies concerning which the exporter as drawer has given no instructions. Hence the exporter should fill out this form completely and carefully, for in case a difficulty arises the presenting bank can obtain additional instructions promptly only by cable which is very expensive. The letter of instruction, as seen above, contains a specific description of the draft, the accompanying documents, and detailed instructions which enable the bank to fill out its remittance letter which accompanies the draft sent to the presenting bank. (See Illustration 15 on page 299.)

While these two instruments present the specific details concerning each bill sent for collection, the general relations among the various parties to the transaction are expressed in two other documents. The sending bank usually informs the drawer of certain standing arrangements which govern the handling of all foreign drafts sent for collection. These terms are usually printed in the acknowledgment sent to the drawer by the bank which thus seeks to contract out various liabilities which it would otherwise assume in receiving items for collection. The nature of these waivers will be discussed elsewhere in this chapter.

The sending bank usually defines its relations with its collecting correspondents in a set of per-

X BANK OF NEW YORK.

Mail to.....

Please report by our No.....

We inclose herewith the item described below:

Client's date or number				Drawer				Drawee				Tenor				Dollar amount			

Original documents (guarantee delivery)								Duplicate documents								To be surrendered upon		Please observe the permanent instructions on the reverse side	
Bills of lading		Insurance certificate		Invoice				Bills of lading		Insurance certificate		Invoice							

Yours truly,

ILLUSTRATION 15

Letter of Remittance

manent instructions printed on the reverse side of the remittance letter, or stated in the general "condition sheet" which regulates such interbank relations as, payment of interest on balances, negotiation of commercial credits, and tariff charges on collections. In the event that the sending bank's

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instructions conflict with the drawer's special directions, the latter take precedence. A typical set of standing instructions reads as follows:

(1) You are hereby authorized to supply our indorsement or to guarantee our indorsement on the inclosed item or any document pertaining thereto where it may have been omitted or incorrectly made. In such event please notify us of your action by mail.

(2) In case of dishonor. — (a) Notify us immediately, giving reason for dishonor (by cable if item exceeds \$500 or equivalent), and protest unless otherwise instructed.

(b) Please try to obtain goods on arrival and have them stored (preferably in bonded warehouse) and insured against all necessary risks for account "whom it may concern" and mail advice to us. It is, however, understood that you may modify these instructions in order to adapt them to laws and usages prevailing in your country and that you may take such action as you deem most expedient in order to protect and promote our interest in the matter.

(c) Necessary disbursements (payment of freight, duty, storage, insurance, etc.) connected with dishonored items or relative goods may be charged to our account. Such charges must be collected from the party retiring the draft unless collection of said charges is expressly waived by us. Our authority should be asked by cable for the payment of relatively large amounts.

(d) Hold draft and documents for instructions from us.

The filling out of the various collection documents is simplified by the use of the fanfold system, which makes it possible at one time to record the specific details of each collection item on several copies which range from 7 to 12 in number. A set thus contains copies which can be used as remit-

tance letters, duplicates for filing purposes, acknowledgments to the sender, tracers, and credit advices.

OPERATION OF COLLECTIONS

The sending bank transmits the collection items to its branches or correspondents abroad. As relatively few foreign branches are operated by American banks, they avail themselves of the services of correspondents. The forwarding of customers' foreign collection items is undertaken by practically all the larger American banks which can readily establish correspondent relations with foreign institutions. Smaller American banks have not sufficient foreign business to warrant maintaining such connections, and instead simply employ the facilities of their metropolitan correspondents. Many foreign banks engaged in overseas financing operate numerous branches, and so the American sending bank may remit drafts either to the head office of their foreign correspondent or to the branch in the locality of the drawee. It is the rule in dealing with European banks to send drafts to the branch nearest the drawee. However, far-eastern banks at times request that outgoing bills from the United States be sent either through their New York agency or to the head office in the Far East and not directly to the branch in the locality of the drawee.

LIABILITY FOR COLLECTIONS

Of practical interest to the exporter is the extent to which he may hold the bank liable in handling an item for collection either through its branch or its correspondent. Ordinarily the drawer of a draft would have the right to hold the sending bank strictly accountable for the proper presentation of the draft by the collecting institution. In England and in some other countries, the courts have regarded a bank taking items for collection as guarantor of the solvency of the subagents which it selects to effect such collections. (*Mackersy vs. Ramsays, etc. & Co.*, 1843, 9 CL: & F. 818.) However, the sending bank, in undertaking to forward the draft for collection abroad, specifically relieves itself of this responsibility. This waiver is printed either in the letter of instruction supplied by the bank and filled out by the drawer, or in the communication which the bank sends to the drawer for the purpose of acknowledging the receipt of his draft. A typical waiver reads as follows:

Owing to the existing conditions in European and other countries, and in order that we may have a clear understanding with our customers and correspondents, we desire to advise that, in receiving items for collection, payable in any foreign country, this bank, acting only as agent for the customer or correspondent, undertakes to use its best efforts to collect and realize upon the same, through established channels or through other banks acting as agents or subagents, but takes such items at the customer's or correspondent's risk until actual

payment to this bank of the proceeds or avails thereof, and without any liability on the part of this bank as a principal for any act, default, loss, or delay of any agent or subagent to whom said items may be sent either directly or indirectly or be forwarded for collection.

While we undertake to use the same care with all such items intrusted to us for collection as we do with our own similar items, we assume no responsibility for any loss in the mails or by reason of any negligence or default of any of our correspondents or any agent or subagent.

While we undertake to exercise due diligence in the selection of any collecting bank or agent or subagent, we wish it understood that we are not to be personally liable as your collecting agent until the actual receipt by us of the proceeds of any such items and we reserve the right to charge back any items for which final payment has not been thus received.

The collecting bank likewise relieves itself of liability to the drawee. On making payment or on accepting the draft, he receives the documents which enable him to obtain possession of the goods, but generally he has no claim upon the sending bank, for it stamps on the remittance letter to the collecting bank the statement: "that it shall not be responsible for the genuineness of the accompanying papers, nor for the quantity, quality, or delivery of any goods referred to therein."

ELEMENTS IN FIXING COLLECTION CHARGES

In collecting a foreign item, the sending bank and its correspondents are compensated for their services out of the collection charge. This varies from one-eighth to one-half of 1 per cent for the

sending bank, and from one-twentieth to 2 per cent for the collecting correspondent. Some banks, however, have arrived at agreements whereby they mutually collect their items free of charge. These differences in rates are caused by the presence of certain elements of cost which are variable in nature. The percentage of the collection charge varies inversely with the size of the bill, since the overhead cost of handling a small item is almost the same as the cost of handling one of larger denomination. A clean bill can be collected more cheaply than a draft accompanied by documents which must be carefully scrutinized. There is also a wide difference in the development of banks abroad and likewise of their collection facilities. The amount of the collection charge also depends upon whether the draft is drawn in dollars or in foreign currencies. If the draft is drawn in dollars, the drawer is usually reimbursed in this currency and so the bank graduates its collection charge, for no profit can be realized from this transaction. If, on the other hand, the bill is drawn in a foreign currency, the sending bank realizes a profit in the conversion of exchange and may reduce its charge or eliminate it entirely.

The collecting bank must carefully observe the sending bank's instructions in such matters as payment of charges, funds in which payment should be made, and the remittances to the sending bank.

PAYMENT OF COLLECTION CHARGES

The charges for collecting a foreign item may be borne either by the drawer, the drawee, or by both, according to the terms of the sales contract. If the charges are carried by the drawer, the collecting bank is instructed to collect from the drawee only the face value of the draft. If the drawee agrees to pay all charges, the sending bank inserts in the letter of instruction a clause which reads: "This item is payable *with all charges for collection and remittance* including stamp duties and our charges, which kindly include in your summary of charges." The sending bank may also stipulate a certain amount to be collected and in this case the letter of instruction bears the statement: "Please collect your own charges plus one-eighth of 1 per cent (minimum \$0.50) for us." Frequently charges are borne by both drawer and drawee, the former carrying the charges of the sending bank, the latter the fees of the collecting bank. If the draft bears no statement regarding the payment of collecting charges, they are not generally demanded of the drawee. The tendency at present is to place collection charges upon the drawer who in turn adds this amount to the selling price.

CLASS OF FUNDS

The nature of the funds in which the drawee is to make payment depends upon the contract of

sale. Where the stipulated amount is in the foreign currency, the drawee delivers to the presenting bank the face amount of the draft. In the case of dollar funds, the sending bank will usually give definite instructions as to what class of dollar exchange shall be paid. The exchange may be sight draft on New York, prime banker's bill, or cable transfer. To cover each case, the letter of remittance bears a stamp such as the following: "Payable at collecting bank's selling rate for check on New York." "Payable in United States dollars prime banker's check on New York." "Payable at collecting bank's selling rate for cable transfer on New York."

In the case of drafts drawn on Australia, New Zealand and South Africa, the remittance letter is stamped with an interest clause known as the "British Colonial clause," which reads: "Payable with collection charges and exchange, British and colonial stamps added, at the current rate in London for negotiating bills on the Colonies." For drafts on non-British colonies the following stamp is sometimes used: "With exchange and collection charges inclusive, interest at 6 per cent per annum from date hereof to approximate due date of arrival of remittance in ———." This interest clause may be inserted in collections on almost all points, but it is most frequently found in drafts drawn on the Far East and Latin America.

FORM OF REMITTANCES

After payment has been made by the drawee, the presenting bank may follow one of several ways in reimbursing the sending bank. It may either credit the account of the latter bank or remit to it the collected funds. The procedure of refunding is determined largely by the currency of the draft. A draft on a foreign country may be drawn either in the local currency of the drawee, in dollars, or in sterling. In the first case, the collecting bank is usually instructed to credit the foreign-currency account of the sending bank. The exact time when the account of the sending bank should be credited varies according to the country or the particular institution. In most cases the sending bank is credited on the date of payment or one day after payment, and in a few instances several days after payment has been made. In Europe it is the general practice to credit the account of the sending bank on the same day if payment is made before noon, and one day later if payment is effected in the afternoon. Where the draft is drawn in sterling, American banks usually instruct their foreign correspondents to remit the sterling proceeds directly to their London branches or correspondents. In a few cases the collecting bank is instructed to credit the sterling account of the sending bank on the date of value. On dollar

drafts the American bank is usually instructed to debit the dollar account of the foreign collecting bank. The actual time of crediting the funds varies, but as a general rule the collecting bank is debited only after the sending bank has received notice of payment.

ANTICIPATORY PAYMENT

In accepting a time draft, a drawee obligates himself to make payment of a certain sum of money at the maturity of the bill. However, he is usually permitted to anticipate this payment by refunding all or part of the amount of the draft before it becomes due, and so he is entitled to a rebate of interest from the date of actual payment to the date of maturity. The rate of this rebate may be determined either by the sending or by the collecting bank. One method is to fix a flat rate of 3 or 4 per cent, depending upon the condition of the money market. In South America and the Far East the rate is naturally higher than in Great Britain and the United States, where money can be borrowed more cheaply. A more exact method of determining the rebate to be allowed to a drawee for anticipatory payments is to fix it in relation to the prevailing bank rate. For example, if the discount rate of the Federal Reserve Bank of New York is 4 per cent, the rate of rebate on anticipatory payments may be 1 per cent lower, or 3 per cent.

PROTEST

The collecting bank presents the item to the drawee, and if he pays or accepts, the transaction is thereby closed. If, on the contrary, he dishonors the instrument, steps must then be taken to protect the interests of the drawer and indorsers. It is customary for the presenting bank to protest the instrument and thus formally certify that the item has been presented to, and dishonored by the drawee.

The exporter must therefore decide whether or not a dishonored note shall be protested. In foreign collections legal protest is not always advisable. True, this procedure gives the drawer or the holder of the drafts certain advantages, but these are purely legal in nature and may be neutralized by possible business disadvantages resulting from the act of protest. The credit standing of the defaulter should be considered. If he is a new customer who has defaulted on his first purchase there is little to be gained by withholding protest. If, however, he is an old client temporarily embarrassed, more may be gained by allowing him time to meet his obligation than by seeking a strictly legal advantage. Also, the value of the customer's future business is a factor which must be weighed.

The procedure of protesting usually involves the services of a notarial officer who legally calls the attention of the delinquent drawer to his obligation

which if still unpaid is entered in the local court records. Whether or not protest is to be made depends upon the instruction received from the sending bank, which in turn acts in accordance with the wishes of the drawer. Foreign banks, acting as collecting agents, will often refuse to protest dishonored bills. This policy in some cases is adopted because the bank recognizes the sheer futility of such action under local conditions. However, the policy of refusing to protest is often taken not so much in the interest of the foreign drawer as for the sake of the local drawee who may be a customer and who may become financially embarrassed by a public notice of his default. When foreign collecting banks thus fail to protest, the matter may be placed in the hands of attorneys, but their services usually prove very costly. For these various reasons, exporters in giving their instructions as to collections do not always insist upon the protesting of dishonored bills. As a general rule, it has been found inexpedient to protest items drawn on certain countries where the cost is prohibitive. This charge is about the same both for non-payment and non-acceptance, nor does it vary with the amount of the draft. The cost is determined largely by the monetary value which the protesting official places upon his services in South America. Protest fees cost about \$5, but in one special case called to the attention of the author the fee amounted to \$100. Outside of South

America, protest is made for non-payment of sight bills, and in the case of time items both for non-acceptance and non-payment. Clean time bills are usually protested immediately upon non-acceptance, while in the case of documentary drafts protest is sometimes withheld until maturity. The exact time when protest must be made varies according to local law, which may follow the Anglo-American law or the Hague Convention Rules of 1912. Usually protest must be made on the day of maturity or not later than 24 hours thereafter, although in some countries the law is broad enough to recognize the legality of a protest made at a date later than the act of dishonor without prejudicing the rights of the drawer. However, this time limit is generally very brief. On the other hand, the holder of the draft, after having protested it, has usually a period of three years or more before the local statute of limitations will debar him from pressing his action against the defaulter.

Drawees frequently refuse to accept or pay documentary drafts because of non-arrival of the goods. Banks are not in agreement as to whether this delay justifies the withholding of protest by the collecting bank. Some banks maintain that the refusal of a drawer to pay a draft because the goods have failed to arrive is no indication that he will not eventually make payment, and so these institutions strongly urge their clients to give instructions

covering this matter. A simple solution is to direct the collecting bank to withhold presentment until the arrival of the merchandise.

PROTECTION OF SHIPPER'S INTERESTS

After protest has been formally made, the collecting bank then takes measures necessary to safeguard the interests of the shipper of the goods. These steps are made only in accordance with the instructions contained in the collection letter, and if this advice does not cover the particular contingency the collecting bank then cables or writes to the sending bank for additional instructions. Both banks naturally aim to prevent the importer from obtaining possession of the goods. The collecting bank therefore enters them at the customhouse as soon as possible in order to avoid additional fines, and stores the goods in a warehouse on behalf of the exporter or his bank. The merchandise is also adequately insured against loss by fire or other contingencies. Acting upon the instructions of the exporter, the bank then makes the necessary preparations either to reship the goods or, if this proves too costly, to dispose of the merchandise through a broker in the local market, and tries to realize the best possible price. If the proceeds derived from this forced sale are insufficient to cover the amount of the bill, the bank upon instructions takes legal action against the drawee for the balance.

HANDLING OF DISCOUNTED DRAFTS — HYPOTHECATION
CERTIFICATES

Consideration has thus far been confined only to the procedure of handling a straight collection item. As mentioned at the beginning of the chapter, the drawer of a bill may sell it to his bank and thus receive immediate credit. In this sense the bill is a cash item and is handled in somewhat different manner than a straight collection item. As the discounting bank is now financially interested in the transaction, it must take proper steps to protect itself, and therefore has the drawer sign an instrument which establishes between them the relation of debtor and creditor. If the drawer sells only a single bill to the bank, the transaction is covered by what is known as an "hypothecation certificate," which opens with a statement which reads: "We have this day sold to (buying bank) our bill of exchange on (drawer) dated ——— for ——— against a shipment of ——— for ——— as per bills of lading herewith." As an exporter is continually selling drafts, it is more convenient for him to sign a document covering all these transactions, and this standing agreement is known as a "general letter of hypothecation."¹ This instrument begins with the following statement:

¹ British banks draw a distinction between a letter of hypothecation and a contract of hypothecation which is really a trust receipt. (See Stead, *Banker's Advances*, p. 119.)

“As you may from time to time purchase from or negotiate for me bills of exchange drawn or indorsed by me with collateral securities, it has been agreed between us that the stipulations contained in this memorandum shall be deemed to be continuing and ambulatory and are to apply to all cases in which such bills of exchange may at any time, either directly or through other persons, be negotiated with or sold to you by me.”

The hypothecation certificate is more abbreviated in form than the general letter, but the two instruments have about the same provisions. In these instruments the drawer agrees to give the bank adequate security to cover its advances. He surrenders all title to the bills of lading representing the merchandise, and also recognizes the right of the bank to insure the goods if the original cover proves unsatisfactory. Thus, if the drawee defaults by not accepting or not paying the drafts on presentation, the bank is protected by its complete control over the merchandise. The bank is at full liberty to enter into any contract for the disposal of these goods, even to the extent of making partial delivery to the drawee or effecting a sale in order to reimburse itself. If the value of the goods at any time is deemed insufficient to cover all the outlays and expenditures of the bank, it may then call upon the drawer for additional margin either in the form of cash or securities.

In signing the hypothecation certificate or letter, the drawer of the drafts also agrees to waive all claims against the sending bank for acts of its

correspondents, delays in transmission, or errors in presentation. Also the drawer yields his right to notice of protest, which he may otherwise require under the uniform, negotiable instruments law of his state.

ENDORSEMENT OF DRAFTS

In buying bills the bank usually insists upon retaining full recourse to the drawer and to the indorsers. Occasionally a bank will discount a draft drawn "without recourse," but only when it feels certain of the position of the drawee and even then it exacts an extra charge known as a "del credere" commission. As a rule the seller writes his unqualified indorsement on the reverse side of the bill. This indorsement must not be made with a rubber stamp, but be signed in ink, and, moreover, bear the official signature of the drawer. These precautions should be rigidly observed for in most foreign countries a rubber-stamped indorsement on a foreign draft is considered illegal and not binding. Also the absence of an official signature to an indorsement may possibly be used as an excuse by the drawee to dishonor the draft.

RELATION OF CONTRACT OF SALE TO DISCOUNTS

A bank discounting a documentary bill must give some consideration to the contract of sale. This document, which expresses the relations between

buyer and seller, is of no interest to a bank discounting a draft under a commercial letter of credit, since American and foreign courts have universally regarded the letter of credit as entirely independent of the contract of sale. But in the absence of a commercial letter of credit, the discounting bank should insist that the documents accompanying the draft conform strictly with the contract of sale, for noncompliance with its terms may cause the drawee to dishonor the bill. While banks do not usually insist that their customers exhibit contracts of sale, nevertheless this right is always held in reserve. As a rule, a bank, in buying drafts from its customer, relies not so much upon the value of the merchandise or the standing of the foreign drawee as upon the financial responsibility of the local drawer.

In the event of default by the drawee, the bank immediately turns to the drawer for reimbursement, and if he is a customer promptly debits his account. As the bank thus cancels its interest in the bill, it is no longer a cash item, but becomes a straight collection item, which must be handled according to the wishes of the drawer and so may again be presented.

As mentioned at the outset, a bank may also share the burden of financing a transaction in foreign trade with the exporter by advancing him a certain part of the draft. The bill is then handled in the same way as a discounted item described above.

KINDS OF COLLECTION ITEMS

Attention has been directed entirely to the handling of drafts, but other items may also be forwarded for collection, such as promissory notes, certificates of deposit, dividend warrants, coupons, securities, mortgage papers, bank pass books, and currency, all of which are handled in about the same way as described above.

REASONS FOR DISHONOR OF DRAFTS

During the past few years, bankers have experienced various problems in collecting items abroad, and have often met with difficulties in obtaining payment. In conclusion, it may be of interest to indicate the causes which have led drawees to refuse payment on drafts. A frequent reason for the rejection of a draft has been the failure of the shipper carefully to observe the contract of sale as to time of shipment or character of the merchandise. Because of unsatisfactory experiences in the past, foreign buyers often insist upon the right to inspect the merchandise before paying or accepting drafts, and a refusal to permit such inspection has caused them to dishonor bills.

The importer claims the right of inspection so that he may be able to assure himself of receiving the exact goods which he has ordered before he parts with his money. The exporter objects to

this practice, since it often gives a trivial excuse for unjustly dishonoring drafts or requesting rebates. With due consideration for both sides it is difficult to see why a reliable importer should not be given the privilege of examination, especially if the exporter is certain that his goods will prove satisfactory. In fact, many exporting houses instruct the bank presenting the draft to permit houses of recognized standing to inspect shipments before honoring the bills. In a recent case (*Henry M. Peabody & Co. vs. Barguero Bros.*, Buenos Aires) the Argentine court denied the right of the plaintiff to recover damages from the defendants who had refused to honor a D/P draft because they had not been permitted to inspect the shipment.

Another difficulty encountered in collecting drafts is the unwillingness of drawees, especially in Latin America, to bear exchange charges. These causes for the rejection of drafts can be easily remedied by a more careful framing of the contract of sale and by a strict adherence to its terms.

During recent years rejections have been caused by other factors, which, however, cannot be readily remedied, since they arise out of the disturbed economic conditions of international trade and finance. In Central and South America, buyers have been at times unable to meet their obligations at maturity, and shippers have been forced to grant extensions of time on these foreign drafts, for abso-

lute insistence for payment would have intensified the critical business situation in these countries. Collections from drawees in Continental Europe have been impeded, due to the general fluctuation in exchanges, and also to the difficulty in obtaining dollar exchange for making reimbursements of collected funds.

CHAPTER XII

FINANCING OF FOREIGN TRADE BY THE IMPORTER¹

The previous chapter has shown how the burden of financing foreign trade may be carried by the importer or by his bank through either the collection or the discount method. The present chapter will describe the financing of foreign trade by the importer or his bank through the letter of credit, the authority to purchase and other instruments.

The disadvantage of both the collection and the discount method to the exporter is the uncertainty of the ultimate payment of the draft by the importer. This element of doubt is to a large extent removed in using the letter of credit or the authority to purchase.

HISTORY OF THE LETTER OF CREDIT

The letter of credit is an instrument long known to international commerce. Reference to it may be retraced to the year 1202 when, according to Macpherson's *Annals of Commerce* (1805),

¹ This subject is discussed at length in the author's study entitled *Foreign Commercial Credits*, and so the following presentation is partly in the nature of a summary of the subject. Several new topics are here considered as supplementary to the previous analysis.

"King John having occasion to send two agents to Rome, where no business could be forwarded without money, furnished them with a letter addressed to all merchants, whereby he bound himself to repay the sums advanced to his agents to the amount of 500 marks at such time as should be agreed upon, to any person presenting his letter together with the acknowledgement of his goods for the sum received."

The letter of credit was also employed by the Jewish bankers and the Lombard money changers throughout the Middle Ages. However, the present form of the letter of credit was developed only about a half century ago by the merchant bankers of England. The enormous flow of exports from the United States to Europe between 1914 and 1920 was financed largely by means of the letter of credit.

MEANING

Letters of credit are either "commercial" or "traveler's," depending upon whether they are used to facilitate the movement of goods or to aid the tourist in obtaining funds for his journey. In this discussion the commercial letter alone will be considered.¹ It has been defined by the author as "an instrument addressed by one party (the issuer) usually a banker acting on behalf of another party (the opener) to a third party (the beneficiary) generally a merchant whereby he is authorized to draw drafts on the issuer who undertakes to

¹ For an explanation of the traveler's letter, see *Foreign Commercial Credits*, Ch. V.

honor, that is accept or pay, them when presented.” (Edwards, *Foreign Commercial Credits*, p. 24.) Thus it is seen that the method of financing foreign trade by the letter of credit differs from mere discounting in that by means of the former the exporter, before even drawing his drafts, obtains an antecedent agreement that these bills will be honored, and so the credit risk is greatly reduced.

CLASSIFICATION — LOCATION

The letter of credit can be used both in foreign and domestic trade, but its application in the latter field depends largely upon the stability of the price level within a country. In the United States and Great Britain the letter of credit is seldom employed in the financing of internal shipments, while its use has been very extensive in Germany and Austria in facilitating domestic trade. In these countries the unprecedented rise in prices has demoralized business relationships and has forced buyers and sellers to protect themselves by wider use of the letter of credit. This document has proven effective in assuring the seller on the one hand of payment on delivery of the goods, and the buyer on the other of the merchandise which he has ordered.

SECURITY

Letters of credit may confer upon the beneficiary an unconditional authority to draw drafts. The

type is known as a clean, or in British practice as an open, letter of credit. However, most letters of credit are documentary in that they authorize payment to the beneficiary only upon the delivery of documents evidencing that shipment has been made.

TENOR

As mentioned above, the letter of credit is essentially an authorization of a bank to a beneficiary who is permitted to draw drafts. The tenor of these bills may be either sight or time. If the beneficiary is permitted to draw a sight or demand bill, he is practically receiving cash for his goods, while if he is authorized to draw a time bill he is being granted an acceptance credit. The latter type prevailed in financing foreign trade before the war, because of the existence of an active acceptance market in most European money centers. Since 1914 and even after the armistice in 1918, these markets functioned only imperfectly, due to the fact that the belligerent governments were absorbing all available liquid funds. The use of acceptance credits has declined especially in countries with a depreciating currency. The unwillingness of banks in these countries to extend acceptance credits becomes quite clear, if one considers the fact that, between the drawing of the bill and its maturity, the gold value shrinks with the depreciation of the currency. Con-

sequently the holder of such bills incurs a loss which cannot be compensated even by a high rate of interest.

CURRENCY

The instability of European exchanges has also influenced the kind of currency of the drafts drawn under the letter of credit. Before the war credits were drawn mainly in the currency of those countries which possessed a discount market strong enough to absorb all drafts offered by holders. However, the greatest use was made of sterling credits because of the strength of the London discount market. The foreign trade of the United States was financed largely through sterling credits, for dollar exchange was practically unknown. These conditions are now entirely altered. Credits in the depreciated currencies are to-day rarely issued, and instead greater use is made of the more stable currencies. The Dutch guilder, Swiss franc, the pound sterling, the Japanese yen and the American dollar form the bases for most credits.

FINANCING METHOD

This tendency of resorting to the currency of a country which is not a party to the shipment has thus led to the increase of the policy of indirect financing. As a result, the machinery for financing foreign trade becomes more complicated and so more expensive, since additional banks are involved.

ASSIGNABILITY

One of the most striking differences between American and European practices relates to the question of assignability. American banks do not recognize the right of the beneficiary to assign his credit to another party unless with the consent of the opener. Under these circumstances the documents are surrendered to the bank negotiating the draft in the name of the original beneficiary and not to the assignee. British banks take a similar stand but are more liberal in their policy of facilitating such assignments. If the letter of credit is addressed to the beneficiary alone, he is not permitted to convey any of his rights to another party. However, a letter of credit may permit the drawing of drafts by a beneficiary or his assigns. In this case the documents are presented by the assignee, but nevertheless the original beneficiary can still be held liable for nonfulfillment of any of the obligations in the credit letter. On the Continent more extensive use is made of the assignable letter of credit which may be addressed to a beneficiary or his order, or even to bearer. This liberality in practice has permitted frequent re-assignments of the same credit which has thus derived the name of a "chain" credit. This practice has led to irregularity and speculation, and European banks are now discouraging the use of assignable credits. In cer-

tain South American countries, including Argentine, Brazil, and Mexico the credit must be made out to a specified party and under no condition to his order.

Indirect assignment may be accomplished by use of the sub credit, or, as it is also known, as an auxiliary credit. This form arises when a beneficiary of a credit seeks to purchase goods and employs his own letter of credit as a security to induce his bank to issue another letter of credit to the seller of the goods. These he ships and obtains payment on the original letter.

On the Continent a sub credit is also called a counter credit, but it must be distinguished from the so-called "counter credit" or "guarantee" in which the beneficiary binds himself to indemnify the opener of the original credit if shipment is not effected according to the stipulated terms.

CANCELLATION AND CONFIRMATION

A bank may issue a letter of credit stating that it will honor the drafts when presented by any holder. The credit is thus described as circular or general, in contrast to a specially-advised or special letter which is forwarded to the beneficiary not directly by the issuing bank but through a notifying bank in his own locality.

When the engagement of the bank issuing the letter of credit is unqualified, the credit is said to be irrevocable. When, however, the letter is con-

ditioned by a statement which reads that the promise of the bank to honor the drafts holds good "unless previously cancelled," the credit is then described as revocable. A credit is said to be confirmed when a second bank, usually in the country of the exporter, adds its guarantee that the drafts drawn on the issuing bank will be honored. Thus confirmation by the second bank has the same force as endorsement. In advising a beneficiary of an unconfirmed credit, the notifying bank is simply authenticating the existence of a credit lodged with the issuing bank. In the United States an irrevocable letter of credit is one which cannot be cancelled by the issuing bank, while a confirmed credit may not be rescinded by either the issuing or the notifying institution.

British banks do not differentiate between the terms "confirmed" and "irrevocable," for they are regarded as synonymous, and hence an unconfirmed irrevocable letter of credit is viewed as a self-evident contradiction. This lack of agreement on terminology has caused considerable misunderstanding and in fact it has led to the misapprehension that American banks do not regard an irrevocable letter of credit as a binding obligation. As a matter of fact, every self-respecting American bank considers itself obligated absolutely to honor drafts drawn under its irrevocable letter of credit if all the terms have been observed. The misunderstanding on this subject is due to the fact that American banks have

introduced the use of the terms "revocable" and "irrevocable," while the expressions "confirmed" and "unconfirmed" are found in British credits. Moreover, the prefixing of the term "confirmed" and "unconfirmed" to letters of credit is only of recent origin. The first reference of an unconfirmed letter of credit in British law appears in the case of *Panoutsos vs. Raymond Hadley Corporation* (1917), 117 *Law Times, Kings Bench*, 330. Most Continental banks recognize the same distinction as drawn by American banks. Unconfirmed irrevocable letters of credit covering shipment between United States and Europe are frequently ordered by importers who are desirous of saving the commission charges of the confirming bank.

Whether a credit is styled "revocable" or "unconfirmed," its essential feature is the fact that it may be cancelled. The question then arises at what particular stage in the transaction does such cancellation become effective. On the Continent it is commonly held that a revocable letter of credit may not be rescinded once the beneficiary has made shipment in accordance with the terms of the credit letter. This view is decidedly favorable to the interests of exporters. In the *Federal Reserve Bulletin*, February, 1921, p. 158, it was indicated that American banks and even merchants do not accept so liberal a view, but rather hold that the beneficiary must at least have presented his documents at the

office of the negotiating bank before cancellation. Most American banks maintain that they may exercise the right of cancelling unconfirmed letters of credit until the time when they have negotiated the drafts of the beneficiary.

Whether the cancellation of a credit may be performed either before the presentation of documents or the negotiation of the drafts depends entirely upon whether or not a bank is compelled to give the beneficiary written notice of the cancellation of the credit. On this subject, American courts have as yet expressed no opinion. However, in the case of *Cape Asbestos vs. Lloyd's Bank* (June 24, 1921, Weekly Notes, 274) the court of Kings Bench decided that a bank advising a beneficiary of an unconfirmed letter of credit was not obliged to give notice of cancellation. This decision was favorably received in London where it was felt that such a verdict was in accordance generally with the historical evolution of the British unconfirmed letter of credit. For many years it was a practice of London acceptance houses not to advise an unconfirmed credit to a beneficiary who was expected to obtain knowledge of this credit from his own customer. After 1914, the joint stock banks entered the field of commercial credits and made a practice of notifying beneficiaries of unconfirmed credits opened in their behalf. While some Continental banks still continue the policy of failing to inform

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STANDARD FORM PREPARED BY THE COMMERCIAL CREDIT CONFERENCE

..... Date.....
(opening bank)

.....
(address)

Dear Sirs:

I/we hereby request you to open and transmit by cable an authority to pay upon the following terms and conditions: irrevocable letter of credit in favor of.....

..... (beneficiary)
for a sum or sums not exceeding a total of..... (amount in words)

available by drafts on
..... (if on applicant, without recourse)
at

..... (tenor of drafts)
if accompanied by the following documents:
Full set of negotiable ocean bills of lading made out to the order of..... Bank
..... (opening bank)

Cross out	Commercial invoice
documents	Consular invoice
not	Marine insurance policy or certificate
required.	War risk insurance policy or certificate
	Certificate of
	Certificate of

evidencing shipment from.....
to..... of %..... invoice
full

cost of.....

..... (description of property)
C.I.F.
..... F.A.S.
..... F.O.B. (vessel) (name of vessel)
shipper

Mine risk insurance to be effected by me/us under blanket policy
Marine
No. issued by.....
..... (name of insurance company)

This credit is (not) to be confirmed by a correspondent bank.
Drafts must be drawn and presented, or negotiated, not later than.....
..... (expiration date)

I/we hereby agree to sign, and deliver to you, an agreement for such credit, in the form now used by you, the provisions of which are agreed to as defining your rights and my/our obligations.

Each of the provisions on the back hereof, except so far as otherwise expressly stated, is to be incorporated as part of the credit.

Yours very truly,

ILLUSTRATION 16

Application for a Commercial Letter of Credit

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COMMERCIAL CREDIT CONFERENCE—FORM B

IRREVOCABLE CREDIT

Credit No. B.....
.....,19....

Dear Sirs:

We hereby open our irrevocable credit in your favor for account offor a sum or sums not exceeding a total of.....(figures)(words) available by your drafts on..... at to be accompanied by..... evidencing shipment of:

From.....Toinsurance to be effected by.....

All drafts so drawn must be marked:

"Drawn under.....Bank
Credit No. B....., dated.....19...."
(To be used when not all the documents are to accompany draft)

There must be forwarded by early mail to.....Bank at.....the following documents..... All remaining documents must accompany the draft.

The amount of any draft drawn under this credit must be endorsed on the reverse hereof, and the presentation of each draft, if negotiated, shall be a warranty by the negotiating bank that such endorsement has been made and that documents have been forwarded as herein required; if the draft is not negotiated this credit and all relative documents must accompany the draft.

This credit must accompany any draft which exhausts the credit and must be surrendered concurrently with the payment of such draft.

Each of the provisions on the back hereof, except so far as otherwise expressly stated, is incorporated as part of this credit.

We hereby engage with the drawers, endorsers and bona fide holders of drafts drawn under and in compliance with the terms of this credit that the same shall be duly honored on due presentation and delivery of documents as specified at....., 19....

Yours very truly,

ILLUSTRATION 17

Irrevocable Credit

beneficiaries of the opening of credits, these institutions generally feel themselves obligated to serve notice upon the beneficiary of the act of cancellation.

RENEWABILITY

Ordinarily a credit is "non-revolving" or not renewable, once the exporter has drawn his drafts up to the amount specified in the letter. A revolving credit, on the other hand, is automatically renewed so that funds are further available to the exporter against additional shipments. A revolving credit has been well described in a recent British case, *Norskog vs. National Bank*, as follows:

A revolving credit is one for a certain sum which is automatically renewed by putting on at the bottom that which is taken off at the top. If you have a revolving credit for £50,000 open for three months to be operated on by drafts at thirty days sight, as drafts are drawn, they temporarily reduce the amount of the credit below the £50,000. As these drafts run off and are presented and paid they are added again to the top of the credit and restore it again to the £50,000. That is what is known technically as a revolving credit, and it is automatic in its operation and does not need renewal. The words 'revolving credit' are used inaccurately in regard to a credit which is opened for a certain amount for so many months, e.g., A credit in favor of A to be drawn on at a rate exceeding £50,000 per month over certain months. It is a credit for a total of £50,000 multiplied by the number of months for which it has been opened and subject to the restriction you cannot draw more than £50,000 in a month. (See also *Foreign Commercial Credits*, pp. 26-27.)

This case illustrates the danger to the bank in issuing a revolving credit, since the defendant in-

stitution could, under the terms of the particular credit in litigation, have been held liable for over a half million pounds sterling. Because of these possibilities, banks seldom issue revolving credits except to especially favored and reliable clients.

OPERATION OF A LETTER OF CREDIT

The actual operation of a letter of credit transaction may be traced as follows:

1. The exporter (A) and the importer (B) enter into a contract of sale which calls for the opening of a letter of credit.
2. The importer requests his bank (C) to open the credit and fills out a formal application (see Illustration No. 17). If the bank accedes to this request, the importer then signs the letter-of-credit contract in which he agrees to reimburse the bank for all outlays and to give it full security for such advances.
3. The bank then issues its letter of credit to the exporter.
4. The exporter in time presents the letter of credit and the draft with the accompanying documents to a local bank (D) which compares all these papers and if in agreement, will negotiate the draft.
5. The negotiating bank then forwards the draft, with the documents, to a correspondent bank (E) in the same city as the issuer of the credit.

6. The correspondent bank then presents the drafts to the issuing bank, which either pays or accepts and thereupon receives the shipping documents. These are turned over to the importer on his signing a trust receipt.

These several steps in the operation of a letter of credit transaction may be illustrated in the accompanying chart.

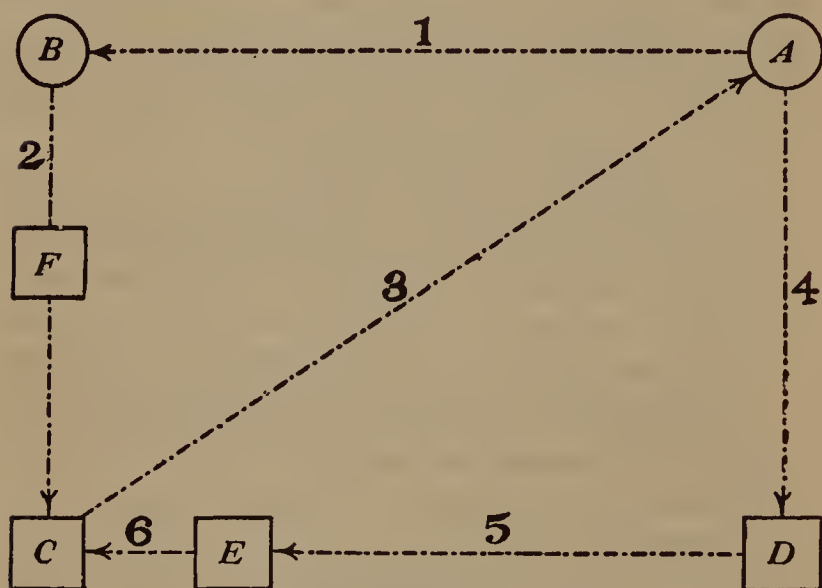


ILLUSTRATION 18

Operation of a Letter of Credit Transaction

OPERATION OF OTHER FORMS OF CREDITS

The above description applies only to the operation of a dollar irrevocable credit. The other forms of credit as classified above involve certain variations. Where an American bank opens a credit

in sterling or in some other foreign currency, the beneficiary draws his draft not upon the issuing bank, but upon its foreign branch or a designated correspondent. The irrevocable credit may be sent not directly to the beneficiary but notified through another bank, which gives the beneficiary either a confirmed or an unconfirmed advice. Another form arises when an inland importer opens a credit not directly with an international bank but indirectly through his local bank (F) which in turn requests a New York City correspondent (C) with international connections to issue its letter of credit.

RIGHT OF RECOURSE

The right of recourse under a letter of credit has been a particular subject of controversy between bankers and merchants. Recourse in this case refers to the liability attached to the exporter as drawer of a draft under a letter of credit. The extent of recourse in law and the degree of liability in practice may best be understood when considered in connection with the more important classes of letter of credit. A letter of credit authorizes the beneficiary to draw his draft upon a bank. If this bill is made at sight, and if on presentation it is duly paid by the drawee bank, by this act any further liability to the exporter as drawer naturally ceases. If, however, the draft is drawn on time, accepted by the drawee bank, and then sold by the exporter to some

purchaser, the latter as bona fide holder first seeks payment from the drawee bank and in the event of non-payment may demand reimbursement from the exporter as drawer of the bill. In this case the accepting bank is primary obligor and carries an actual liability, while the merchant drawer, as secondary obligor, carries a contingent liability since, under the Negotiable Instruments law (Section III, New York), he "engages that on due presentation the instrument will be accepted and paid, or both, according to its tenor and that if it be dishonored, and the necessary proceedings of dishonor be duly taken, he will pay the amount thereof to the holder, or to any subsequent indorsor who may be compelled to pay it." The same view is taken in British law in the Bills of Exchange Act 1882 s/55-i-(a). Thus, under both American and British Law in the case of an acceptance credit, the drawer is not relieved of his liability as party to a negotiable instrument. While the exporter thus carries a liability, it is merely contingent, and becomes actual only if the drawee bank should fail. In practice the extent of the merchant's true liability depends upon the solvency of the accepting bank. When, therefore, he draws upon a strong American institution, the possibility of his ever being called upon to make restitution because of the insolvency of the acceptor is indeed remote.

So far dollar credits have been considered, but the

above conclusions apply also to credits drawn in other currencies and upon foreign banks. In a way, this type of credit offers the beneficiary even greater protection, since the letter bears the statement that the American bank as issuer assures all holders of drafts drawn under the terms of the credit on their foreign correspondents that such drafts will be paid.

Thus, in the event of the failure of the foreign bank, the merchant as drawer would be compelled to satisfy the claims of the holder of the dishonored instrument, but the merchant could then obtain reimbursement from the American bank which, under the letter of credit, had guaranteed the obligations of its foreign correspondent.

The controversy over recourse is largely waged in relation to revocable and irrevocable credits. The thought is quite commonly expressed that irrevocable credits relieve the beneficiary of all recourse, while revocable credits alone charge such liability to the drawer. As a matter of fact, there is actually no relation between the question of revocability and recourse, since the observations made above apply to both classes with equal force. Thus in summary, whether credits are drawn in dollars or in foreign currencies, or whether issued in revocable or irrevocable form, recourse is extinguished upon payment in the case of cash credits but continues even after acceptance by the drawee bank in the case of time credits.

The liability under even this type of credit may be eliminated if the merchant draws his draft "without recourse." However, the drawing of a bill in this manner impairs its marketability since it is ineligible for rediscount at Federal Reserve Banks.

MOVEMENT TOWARD UNIFORMITY

The period from 1914 until the present has witnessed the most precipitous changes in the price level known to economic history. Especially serious have been the disturbances in the field of foreign trade where widespread cancellation of orders brought great concern to merchants and bankers. These changes have wrought broad results which as yet are unmeasured. More easily discernible are the effects on commercial law and banking practice.

With the collapse of prices in 1920, the letter of credit, as the fundamental instrument expressing the legal relationship among the various parties to a foreign trade transaction, became the subject of sharp discussion and litigation. As a contribution to the better understanding of the nature and principles of the letter of credit, the author undertook on behalf of Federal Reserve Board a survey of the legal and practical aspects of this instrument. Analysis was first made of American and British cases which were set forth in the *Federal Reserve Bulletin* of February, 1921, pp. 158-163. As there was little agreement either among bankers or mer-

chants regarding the use of the letter of credit, their views were also solicited and summarized in the *Bulletin* (pp. 163-171, 681-688). The conflicting views of these parties found expression in the wording of their letters of credit, and a comparative study was made of American forms (*ibid.*, 410-415).

These studies served partly as a basis for framing a set of uniform letter of credit instruments by the Commercial Credit Conference, of which the author was a member. The American Acceptance Council undertook the task of inducing American banks to adopt these standardized forms. This movement, although worthy of the support of all American banks interested in foreign trade financing, has developed but slowly, owing to the highly competitive nature of the American banking system and the consequent difficulty of obtaining interbank co-operation. The movement toward uniformity of documents and standardization of practice will in the future progress more rapidly in European countries where banking is more concentrated and where united action is, therefore, more readily attained.¹

¹ See Spalding, *Bankers Credits* (English); Marais, *Credit Documentaire* (French); Koch, *Warenkredit der Banker*, Jacobi, *Das Akkreditiv*, *Bank Archiv*, Vol. XX (German); Oberparleiter, *Dokumentare Akkreditiv* (Austrian).

DIFFICULTIES IN LEGAL ANALYSIS OF THE LETTER
OF CREDIT

A recent British commentator on the current law of commercial credits expressed his appreciation of the scope of the task to which he had set his hand in the following words:

"No more obscure or difficult problem has arisen in connection with the law of banking during the post war period than that of defining the respective rights and liabilities of the parties concerned in the intimate process of financing for trade by means of banks' commercial credits." — *Economica* (1923), p. 35.

The difficulty in analyzing the legal nature of the letter of credit arises from the fact that the law has been interpreted without a full appreciation of the changes which have taken place in banking practice.

The economic crisis of 1920, which witnessed a severe collapse of commodity prices in all parts of the world, was followed by a repudiation of commercial obligations hitherto unheard of in the history of business. As a result, the various instruments of credit, particularly the letter of credit, which defined the rights and liabilities of parties to transactions in international trade, became the basis for numerous cases carried before the courts of the more important commercial countries of the world. At this juncture the judicial machinery failed to function with efficiency, owing to the fact that the law on commercial credits had not developed apace with the evolution in mercantile practice. Although the

letter of credit had been the subject' of judicial opinion and juristic comment for several centuries, it must, however, be remembered that in this period the instrument was drawn in a form entirely unlike that which it assumes at the present time. The old letter of credit was quite similar to the present-day traveler's letter, in that it was essentially a request by one party to another to give credit to a third party. The modern letter of credit is not a request for credit, but rather a grant of credit.¹

Another reason for the confusion between the law and practice of credit letters has been due to the difference in the breadth of the definition of the instrument. In business usage a letter of credit is a formal document issued by a bank. In law, a letter of credit is more widely interpreted, and may include any form of written statement, even a simple memorandum or a telegraphic message. Also in law, a letter of credit may not alone be written by a banker, but by one merchant to another. In commercial practice such a document would have no value and would not be recognized, for actually a letter of credit can be issued only by a banker.

For legal definitions of letters of credit see the following:

¹ The court in *American Steel Co. vs. Irving National Bank*, 266 *Federal Reporter*, 41, defined erroneously a commercial letter of credit. The same mistake occurs in an otherwise excellent legal review of the letter of credit in the *Bulletin of the American Institute of Banking* (1923, p. 408).

Story, *Bills of Exchange*, 3 Ed., Sec. 159 (1853); Byles, *Bills of Exchange*, 16 Ed., p. 111 (1899); Chalmers, *Bills of Exchange*, 6 Ed., pp. 184-185 (1903); 2 Daniel, *Negotiable Instruments*, 6 Ed., Sec. 1790 (1914); 18 *American and English Encyclopædia of Law*, 2 Ed., p. 831 (1911); *Liggett and Levy vs. Union National Bank* 233 Mo. 590, S. W. 299; *Bank of Montreal vs. Thomas* 16 out 503 (1888); *Bissell vs. Lewis* 4 Mich. 450 (1857); *Union Bank of Louisiana vs. Coster* 3 N. Y. 203 (1850); *Birkhead vs. Brown* 5 Hill (N. Y.) 634, (1843); *Johannesen vs. Munroe* 84 Hun. (N. Y.) 594 (1895).

The law has also failed to appreciate another change in commercial practice even more vital than the alteration in form noted above. For years letters of credit represented transactions in actual cash. Before issuing his letter of credit, the goldsmith, the merchant or the banker of the past, would require the depositing of a sum of money in the nature of a trust fund. This method disappeared with the coming of the credit system, and so letters of credit of to-day no longer represent a cash operation but instead a credit transaction. An examination of the numerous cases dealing with letters of credit as tried in American, British, and Continental Courts discloses the fact that few of these decisions have any bearing on the rights and liabilities of parties to the present-day letter of credit. Especially is this true

of decisions under Continental and particularly French law (see 4 Lyon-Caen et Renault, *Traite de Droit Commercial*, 4 ed., sec. 736-48; 2 Sec. 633-41; 2 Pardessus, *Cours de Droit Commercial*, Sec. 585; Pothier, *Traite du contract de Change*, sec. 236).

Hence, for an understanding of the present legal problems surrounding the letter of credit, attention may be confined largely to the more recent decisions, especially those which have arisen in American and British courts.

LEGAL THEORIES ON NATURE OF LETTER OF CREDIT

RELATION BETWEEN ISSUER OF CREDIT AND PURCHASER OF DRAFTS

Before entering upon a consideration of the rights and liabilities of the various parties to a letter of credit it is necessary, first, to analyze the various theories which have been propounded to explain the legal nature of the instrument. The modern commercial letter of credit consists of two parts, namely, an authorization to the beneficiary to draw his draft on the issuing bank and a promise to the holder of the bill that it will be honored when presented. A number of jurists have failed signally in their efforts to evolve a satisfactory legal basis for the letter of credit because of their refusal to distinguish between these two component elements in

the instrument. As they are different in nature, a separate treatment must be accorded to each.

Consider first the promise of the issuing banker to the holders of drafts drawn under its letter of credit. A typical engagement of the general type reads thus:

We hereby engage with the drawers, endorsers and bona fide holders of drafts drawn under and in compliance with the terms of this credit that the same shall be duly honored on due presentation and delivery of documents.

From the language of the above undertaking it is clear that the bank extends an offer, general in this case, which is accepted by another bank when it purchases the draft of the beneficiary. As far as the issuer of the credit and the negotiator of the draft are concerned, the engagement may be either specific, in the case of a specially-advised credit which can be negotiated only with one bank, or general in a circular credit, which permits the beneficiary to discount his draft at any institution he may approach.

Between the issuer of the credit and the purchaser of the underlying draft, the letter of credit is beyond doubt a contract. This view was taken in *Russell vs. Wiggin*, 2 *Story* 213, 1842, by Justice Story, who stated that "the party, the banker, giving such a letter, held himself out to all persons, who should advance money on bills drawn under the same, and upon the faith thereof, as contracting with them an obligation to accept and pay the bills."

However, in the same case the expert testimony of four well-known English barristers was introduced to show that:

by the law of England a promise (as contained in a letter of credit) to accept a non-existing bill of exchange even though it be taken by the holder (the negotiating banker) upon the faith of that promise, does not amount to an acceptance of the bill, when in favor of the holder.

In other words, according to these views, no contract existed between the issuer of the credit and the negotiator of the drafts. This opinion was not followed in the first actual case which came before the British courts, for in *Agra and Masterman's Bank, ex-parte Asiatic Banking Corporation*, L. R. 2 Ch. App. 391 (1867), the court rendered the following opinion:

The letter is a general invitation issued by the Agra & Masterman's Bank (issuer), through Dickson, Tatham & Co. (beneficiary), to all persons to whom the letter may be shown, to take bills drawn by Dickson, Tatham & Co. on the Agra & Masterman's Bank with reference to the letter, and to alter their position by paying for such bills, and an assurance that, if they or any of them would do so, the Agra & Masterman's Bank would accept such bills on presentation. Upon the offer in this letter being accepted, and acted on by the Asiatic Banking Corporation (negotiators), there was constituted a valid and legal binding contract against the Agra & Masterman's Bank (issuer) in favor of the Asiatic Banking Corporation. (Re: Agra & Masterman's Bank (865) 36, L.J. Ch. 222.)

In the recent case of *Urquhart, Lindsay & Co. Ltd. vs. Eastern Bank Ltd.*, 9 Lloyd's List Law

Rep. 572 (K. B. D. decided Dec. 5, 1921), the court again affirmed the offer theory in the following words:

There can be no doubt upon the plaintiffs' acting upon the undertaking contained in this letter of credit, consideration moved from the plaintiffs which bound the defendants to the irrevocable character of the arrangement between the defendants and the plaintiffs. . . . The credit was irrevocable; and the effect was that the bank really agreed to buy the contemplated series of bills and documents representing the contemplated shipments, just as the buyer agreed to take, and pay for, by this means, the goods themselves.

Thus, in both American and British law, that part of the letter of credit which affects the relation between the issuing bank and a bona fide purchaser of a draft drawn by virtue of it is a direct contract.

RELATION BETWEEN ISSUER OF CREDIT AND BENEFICIARY

So simple a solution will not serve to explain the legal nature of the relation between the issuing bank and the beneficiary, as created by the letter of credit. In fact, a wide and confusing variety of legal theories have been suggested. Several of them may be discarded at the outset, since they do not apply to the modern commercial letter of credit, which alone is under consideration.

THEORY OF EQUITABLE ASSIGNMENT OF FUNDS
ON DEPOSIT

One theory of the legal nature of a letter of credit regards it as a representation that the issuing bank is holding money for the use of the beneficiary. The ablest exposition of this theory is given by Omer Hershey (32 *Harvard Law Review*, 1).

In actual practice the opening of a letter of credit does not usually involve the placing of cash with a bank, for in most cases it represents a pure credit transaction. It may as well be argued that a deposit account of a customer with his bank represents money actually placed with the bank, when as a matter of fact it may possibly be created by the bank granting accommodation to the customer and evidencing this advance by so much credit on its books in favor of the latter. In the same manner, a letter of credit usually signifies an extension of credit by the banker, and so the legal theory which regards the letter of credit as a representation of funds held by the banker for the beneficiary is not founded on fact. The theory was flatly rejected almost a half century ago by the British courts in an able decision rendered in *Morgan vs. Larivière* (1875 L. R., 71-1). (See also 35 *Harvard Law Review*, 584 (1922); 21 *Columbia Law Review*, 507 (1921); 22 (1922), 302.)

THEORY OF ESTOPPEL

The above contention that the bank has received funds to meet the drafts of the beneficiary is usually combined with the theory of estoppel, which holds that the bank is estopped to deny this representation after the beneficiary has acted in reliance upon it. This line of reasoning is followed in *Johanessen vs. Munroe* (84 Hun. 64), but must also be rejected since it does not coincide with actual practice as explained above. (See also study of the author in *Federal Reserve Bulletin*, 1921, p. 158-163.)

The theory of estoppel is well refuted by Carl Mead, in 22 *Columbia Law Review*, p. 302, as follows:

To make a person liable by estoppel, he must have made a false representation as to an existing fact. The representation in this case might be strictly true that the purchaser of the goods has, at the time when the credit is issued, deposited funds with the issuing bank sufficient to meet the drafts. The letter of credit, however, involves the further representation that these funds will be held by the bank and utilized for payment of the drafts. This representation is not as to an existing fact, but is promissory in its nature and consequently cannot be the basis of any liability by estoppel.

THEORY OF GUARANTY

The letter of credit is sometimes regarded as a guaranty of the issuing bank, whereby it assures reimbursement for all advances granted by others to the beneficiary. This theory may well be applied to the traveler's letter of credit or to the communi-

cation sent by a bank asking a correspondent to confirm a credit, but it cannot be extended to the commercial letter, since the bank as issuer grants the credit directly to the beneficiary and, therefore, acts as primary and not as secondary obligor.

THEORY OF OFFER

The prevailing conception of the legal nature of a letter of credit regards it as an offer by the issuing bank, acting for the opener, in anticipation of a unilateral contract. This will be created when the beneficiary takes steps to accept the offer by presenting a draft drawn in accordance with the terms of the credit, which may call for certain accompanying documents. Thus, one party, the bank, undertakes an obligation without receiving in return any counter promise from the other party, the beneficiary, but instead receives, as consideration of such obligation, a promise of the performance of some required act. (See opinion in *Doelger vs. Battery Park National Bank* (1921), 3 Journal of Commerce 9.)

An offer in law may be withdrawn by the offerer at will any time before its acceptance by the offeree. Thus it would seem that the offer theory cannot well be applied to the "irrevocable" letter of credit. Although the courts have quite generally followed the offer theory, they have at the same time supported the inviolability of the "irrevocable" letter of credit.

Regarding this apparent inconsistency, Mr. Karl T. Frederick, a member of the New York bar who has given deep thought to the legal analysis of foreign credit instruments, in a letter to the author suggests the following analogy:

It seems to me that it may be helpful in trying to understand and to explain this state of affairs, to suggest an analogy. What are known as "options" are old and well recognized forms of agreement. In a loose sense, they are "irrevocable" offers. Strictly, however, an option consists of an offer accompanied by a collateral contract that the offer will not be revoked for an agreed period. This collateral contract is based on independent consideration. While the enforcement of this collateral contract is specific enforcement, yet the courts have never found difficulty in granting it even in cases quite beyond the usually recognized field of specific performance.

If we apply the analogy to letters of credit, we find that the collateral contract is made between the buyer and the bank. The bank at the request of the buyer makes an offer to the seller and contracts with the buyer for an independent consideration (a commission, etc.) that he will not revoke the offer. Revocation would constitute a breach of this contract which has been made in pursuance of the contract between the seller and the buyer.

When the seller seeks to compel the bank to live up to its offer, i.e., to its "irrevocable" letter of credit, the question arises whether the case is not one of enforcing a contract for the benefit of a third party. This conclusion is not necessary. It is enough for the court to decline to hear a defense based on revocation when such defense necessarily implies a breach on the part of the defendant of a collateral contract which appears on the face of the instrument in question. In other words, the court will not permit a defendant to assert his own wrong as a defense to a suit.

If it be asked whether the bank and the buyer cannot agree

to the termination of the collateral contract, thus permitting the withdrawal of the offer, it may be suggested that this would also involve a breach on the part of the buyer of the contract between himself and the seller of which the bank had notice and that such a defense is equally inadmissible."

LEGAL RIGHTS AND LIABILITIES UNDER LETTERS OF CREDIT

During the past half century, British and American courts have rendered decisions in about two hundred cases bearing on the legal relations of parties to letters of credit. While only about fifty of these cases deal with the modern or commercial form of letter of credit, nevertheless, these decisions have, especially since 1920, defined quite clearly the rights and liabilities of the several parties involved in letter of credit transactions. The principles developed in these decisions may be summarized as follows (for analysis of the cases see Edwards, *Foreign Commercial Credits*, Ch. VI, VII, XI):

1. A bank may not cancel its clean irrevocable letter of credit under which a third party has negotiated drafts properly drawn by the beneficiary.

2. A revocable letter of credit may be rescinded by the issuing bank upon notice to the beneficiary.¹

3. An unconfirmed advice of a credit may be revoked by the adviser without notice to the beneficiary.¹

¹ Has been decided by British but not as yet by American courts.

4. A bank cannot revoke its clean letter of credit, nor refuse drafts drawn thereunder, because drafts presented by the negotiator have been drawn in violation of a sales contract of which the negotiator has no knowledge.

5. An issuing bank may refuse to honor drafts drawn under its letter of credit if such drafts as presented by the negotiator are in violation of the letter of credit because of failure to observe general terms.

6. An issuer of an authority to draw (see p. '355) is liable to the opener if the terms are not observed by the beneficiary:

7. A bank negotiating drafts under a letter of credit is not responsible for the genuineness of the documents presented by the beneficiary:

a. Bill of lading.

b. Certificate of analysis.

8. A bank negotiating drafts under a letter of credit is not responsible for the quality of the goods shipped by the beneficiary.

BUSINESS RIGHTS AND LIABILITIES UNDER LETTERS OF CREDIT

Aside from the strictly legal aspects of the letter of credit, as an instrument of commerce, it should safeguard the business rights of all interested parties, including the following:

- (1) The importer or buyer of the goods.
- (2) The exporter or seller of the goods.
- (3) The issuing bank.
- (4) The negotiating bank.

The importer has a right to demand that payment be made to the exporter only when he has met the conditions specified in the letter of credit. These stipulations usually call for the production of certain documents, as bills of lading, insurance policies, commercial and consular invoices, and other certificates before a fixed expiration date.

The exporter is mainly concerned in being paid when his shipments are ready for delivery. He regards the letter of credit as a means of binding the sales contract between himself and the buyer of his goods. This absolute assurance he may receive through an irrevocable letter of credit which definitely informs him that he will receive payment conditioned only upon delivering the documents listed in the credit. Furthermore, the seller is not dependent upon the integrity of his customer, but he is now relying on a superior form of credit, for the obligation to pay is placed upon the banking house which has issued the letter.

The credit-issuing bank induces the seller to part with his goods by lending its name to the transaction. The bank is really substituting its better-known credit for the less-known standing of the buyer. As it is therefore performing a straight banking func-

tion, it should have no interest in the commercial risk. The credit-issuing bank has, however, an obligation to both parties mentioned above. To the seller it assumes a definite engagement to honor his drafts, and to the buyer it gives assurance that such payment will be made only if the terms are observed. Naturally, as the latter is the customer of the bank, it will write into the letter those details necessary to protect the buyer. But overloading the letter with specifications may vitiate the negotiation of the drafts. Here is an unsettled policy among banks engaged in financing foreign trade. Very often a bank will insist upon details in a letter of credit covering an import of goods, and in an export transaction will strongly protest against the inclusion of such conditions. Unquestionably, American banks negotiating export credits are fully within their legal rights when they insist that they are concerned only in the technical observance of the terms of a credit as evidenced in the documents presented by the exporter. But in the interest of the trade of the nation our banks are morally bound to exercise care in insisting that American sellers of merchandise satisfy the wishes of foreign buyers when expressed in the letters of credit.

Aside from the question of confirmation, the bank negotiating drafts under a letter of credit must exercise care in comparing the documents prescribed by the exporter with the terms specified in the letter.

THE AUTHORITY TO PURCHASE¹

The primary function of the letter of credit is to give the exporter a definite assurance of payment for the shipment which he is forwarding to the importer. This end is also accomplished especially in the financing of exports to the Far East by the use of an instrument known as the "authority to purchase." Its nature may best be understood by comparing it with other methods of trade financing. In the previous chapter it was seen that an exporter, after drawing a draft on an importer, was not always able to market the bill. This would prove especially true in the case of bills drawn on countries such as those in the Far East where banking facilities are undeveloped and credit conditions uncertain. To assure a market for such trade bills, the authority to purchase method is employed. Its operation and the documents involved are explained as follows:

(1) The Far-Eastern importer (A) sends to the exporter (B) a communication known as an "authority to draw," which states the terms of sale and confers upon the latter the right to draw drafts upon the former.

(2) The importer addresses to a Far-Eastern bank (C) a "letter of application and guarantee" in which he asks the bank to issue its authority to

¹ For a fuller consideration see *Foreign Commercial Credits*, Ch. VIII.

purchase and gives assurance that he will make reimbursement for all advances and services rendered.

(3) The Far-Eastern bank then issues its "authority to purchase" to a foreign correspondent (D) which is requested to negotiate the drafts of the exporter.

(4) This bank then sends to the exporter an "advice of authority to purchase," notifying him that it has been instructed to negotiate his drafts if accompanied by proper documents.

These successive steps may be illustrated in the following diagram:

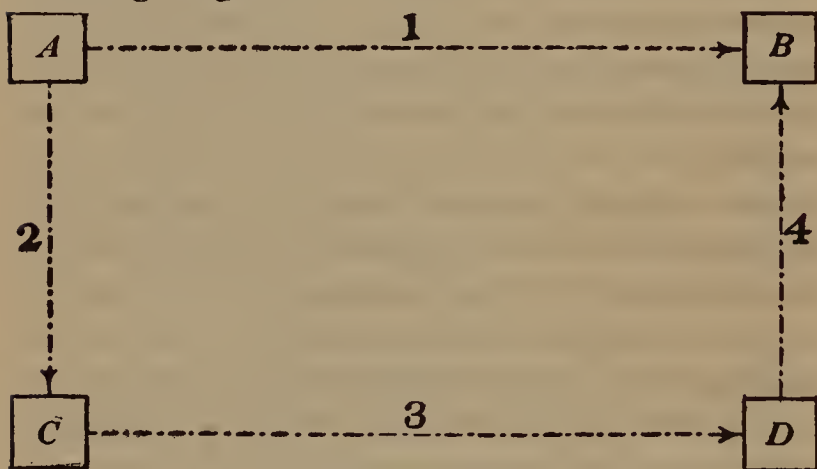


ILLUSTRATION 19

Operation of an Authority to Purchase Transaction

CLASSIFICATION

Authorities to purchase may be classified in much the same manner as the letter of credit. However, the authority to purchase usually permits the

exporter to draw his drafts without recourse. A without-recourse, irrevocable authority to purchase is sometimes called a confirmed letter of credit.

COMPARISON BETWEEN LETTER OF CREDIT AND AUTHORITY TO PURCHASE

The letter of credit and the authority to purchase have several characteristics in common. They perform the same function of placing the burden of financing a foreign trade transaction upon the importer. They both confer the right to draw drafts which practically give the exporter cash payment. Both instruments involve a set of ancillary documents which are quite similar in nature. Also the legal principles governing the letter of credit may be extended to the authority to purchase. For cases on the authority to purchase, see *Bank of Plant City vs. Canal-Commercial Trust and Savings Bank* 270, Fed. 477 (1921); *Lemon Importing Co. vs. Garfield Saving Bank*, 187, App. Div. 932, 173 N. Y. Supp. 551 (1919); *Friedlander vs. Bank of Australasia* 8 C.L.R., H.C. Australia 85 (1909); *Basse & Selve vs. Bank of Australasia* 90, L.T.R. 618 (1904); *Borthwick vs. Bank of New Zealand*, 17, T.L.R. 2, (1900); *Waterson vs. Edinburgh & Glasgow Bank* 20 CT Sess. 642 (1858.)

The letter of credit and the authority to purchase differ as to use, tenor, currency, credit and marketability. The letter of credit is universal in use,

while the authority to purchase is confined to Far Eastern and in rare cases to South American trade. Moreover, the authority to purchase usually calls for the drawing of time drafts and so creates mainly acceptance credits. Owing to the uncertainty caused by this time element, exporters usually insist that drafts under an authority to purchase shall be drawn in dollars. The essential difference between the letter of credit and the authority to purchase lies in the fact that the former gives rise to bank bills and the latter to trade drafts. These have a limited market and can be discounted only at a relatively high rate of interest.

BANK GUARANTY

Similar to both the letter of credit and the authority to purchase is the bank guaranty. All three instruments are issued by a bank, which thereby gives the exporter a greater degree of assurance that he will receive payment for his shipment. A typical guaranty reads as follows:

We [the guaranteeing bank] hereby guarantee payment to you [the seller] of sight drafts on the X Company [buyer] against complete shipping documents, bills of lading for the shipment of three thousand bushels of number two hard winter wheat at one dollar and fifty cents a bushel if presented before the end of March, 1924.

The bank guaranty operates very much the same as an authority to purchase in that both instruments give rise to trade drafts or bills drawn on the im-

porter. Bank guaranties are not generally required on exports to stable countries like the United Kingdom, but they are often demanded in dealing with Europe. Sometimes a bank does not guaranty the full value of the draft but only a proportion such as one fourth or one half of the value of the bill.

These guaranties are not generally granted by American banks, since they are prohibited under the National Bank Act and also under the laws of many states, from guaranteeing the obligations of other parties. Hence, most guaranties covering exports are issued by foreign banks free of legal inhibitions or by American private institutions. Canadian and British banks thus aid in financing a not inconsiderable proportion of wheat shipments. In exporting grain, meats and cotton to Central Europe, a guaranty is often required, but American exporters usually insist that the guaranty be granted by a strong bank located in a country of stable currency, such as Holland or Switzerland.

LETTER OF DELEGATION

In closing this discussion on the methods of financing trade by the importer, mention should, in passing, be made of the letter of delegation. This instrument is of peculiar interest since it enables the payment of a shipment without the employment of any drafts.

The letter of delegation is thus quite similar to

the open account method, since no draft is involved, but, of course, the former method places the financial burden upon the importer and the latter transfers it to the exporter. In the fact that it does not give rise to a draft lies the reason for the use of the letter of delegation which thus saves the stamp duties required on ordinary negotiable instruments. Under British law the letter of delegation is regarded the same as a bill of exchange and so is not exempt from the usual charges. Before the war, German importers, especially in the grain business, made payments by means of the letter of delegation and so saved stamp duties.

The letter of delegation is really an order by which the exporter empowers a bank to collect certain funds due from a foreign importer. A typical form reads as follows:

Letter of Delegation. No. 2401

Dear Sirs:

Kindly pay upon receipt of this letter (all other copies being unpaid) to:

for account of

by order of

the sum of

to our debit, under prompt advice.

Yours very truly,

SUMMARY

The various methods as described in the two foregoing chapters, whereby the burden of financing a foreign trade transaction may be shifted, is summarized in the following chart:

Summary of Methods of Financing Foreign Trade

	CASH TERMS	CREDIT TERMS
	FINANCING BY THE IMPORTER	FINANCING BY THE EXPORTER
Without drafts	Letter of Delegation	Open Account
With drafts	Documents upon Payment (D/P) (straight collection)	Documents upon Acceptance (D/A) (straight collection)
	FINANCING BY THE IMPORTER'S BANK	FINANCING BY THE EXPORTER'S BANK
	Letter of Credit Authority to purchase Bank guaranty	Advance collection of draft Discount of draft Refinancing acceptance

CHAPTER XIII

BANK CREDIT POLICY

PRINCIPLES OF GENERAL CREDIT

The two preceding chapters have described the technical method whereby foreign trade is financed either on the part of the exporter or of the importer. It was there seen that the financial burden could be shared by these parties with their respective banks, and so foreign trade may be financed either by mercantile or by bank credit.

At the outset of Part II, which deals with foreign trade financing, consideration was given to the operation of commercial credit as extended between business houses themselves. It was there seen that the transactions between these two parties could be settled as follows:

1. The financial burden could be carried by the buyer of the goods (B) in paying cash.
2. The burden could be assumed by the seller (A) in allowing time settlement.
3. The burden could then be shifted by either the buyer or the seller through borrowing from their respective banks (C,D).

The movement of the credit burden may be illustrated in the diagram given on page 363.

The two previous chapters have described the methods of trade financing by both the importer's and the exporter's bank, but have dealt with the subject from the viewpoint of the business man as the borrower. These extensions of credit will now

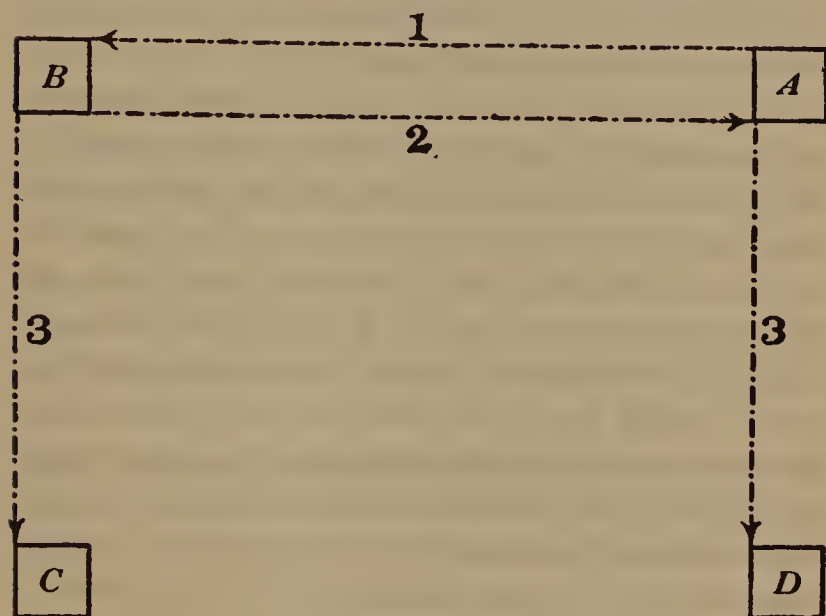


ILLUSTRATION 20

Movement of the Credit Burden

be approached from the standpoint of the bank as lender.

FORMS OF BANK CREDIT

A bank is essentially a credit institution which functions for the purpose of facilitating the exchange of goods between buyers and sellers without the use of money. Through scientific analysis a bank first tests the credit of a prospective borrower, and if

this test proves satisfactory, the bank then guarantees the credit of the business man. He thereby receives added buying power through the action of the bank in substituting its well-known credit in place of the less-known credit of the borrower.

In thus lending its credit, the bank may give the borrower the loan in the form of bank notes, which he may circulate in the community or of deposit credit against which he may draw checks. These notes and deposit entries constitute demand obligations on the bank for which it holds either a demand or time obligation of the customer. However, the bank can substitute its credit in place of that of the borrower, neither by issuing notes nor by creating deposits, but by accepting drafts drawn upon it. While such acceptances are generally similar in nature to notes and drafts, the essential difference lies in the fact that the acceptance itself is a time obligation of the bank based on a time obligation of the borrower.

PRINCIPLES OF ACCEPTANCE CREDIT

International credit is created mainly by means of the banker's acceptance which may be used to finance the movement of goods through all the successive stages of marketing from the point of origin to the final destination.

In the period from the close of the Napoleonic conflict until the opening of the Great War, England and certain of the Continental nations employed the

banker's acceptance extensively in financing the world's trade. As a result of this experience the banks of these countries gradually developed practices and principles which came to be recognized generally as sound. Although the interpretation of these principles have often varied, they can be stated simply and briefly. In fact, the science of acceptance credit may be summarized in the one fundamental law that the paper must be self-liquidating, or in other words that it must provide the means of its own payment at maturity. In order to accomplish this end, the bill must be based on a specific, completed business transaction whereby a particular shipment of goods is transferred from a seller to a buyer. The latter in time makes payment, and as a direct result furnishes the funds for meeting the acceptance at maturity, and so automatically extinguishing the claim. It must, therefore, follow that a close relation should exist between the maturity of the banker's acceptance and the close of the underlying business transaction. The bill should be so drawn that its date of maturity will be coterminous with the time of settlement by the purchaser of the goods. Since the bank thus obtains reimbursement for its outlays out of the proceeds derived from the sale of the goods, these are of direct interest to the bank. It should, therefore, retain complete control over them, or rather over the set of documents evidencing title to them. Although an acceptance credit is thus secured

by the underlying goods, and although it does not involve the advancing of actual cash by the bank, nevertheless this institution must exercise the same care and follow the same principles of sound banking as in the granting of ordinary loans. Credits should not be extended on a single form of collateral, for even staples such as cotton and wheat are subject to sharp price reductions which will materially affect the value of the underlying security. Furthermore, acceptance credits should not be granted over-liberally to any single party, but instead should be well distributed. A bank in assuming acceptance liabilities is performing a function similar to an insurance company, which by necessity must spread its risks.

Thus, from the simple principle that an acceptance credit must be self-liquidating, the following corollaries may be derived.

1. The credit must be based on an actual business transaction.
2. Its maturity must coincide with the settlement of this transaction.
3. The underlying goods and the proceeds of their sale must be controlled by the bank.
4. The entire credit extension must be governed by the general rule of wide distribution.

ADVANTAGES OF THE BANKER'S ACCEPTANCE

Bills drawn in accordance with these principles constitute commercial paper of the highest quality and carry distinct advantages to all parties concerned. The seller of goods on a banker's acceptance basis is relatively certain of payment for he holds the definite promise of a bank. The buyer derives an advantage from the use of the banker's acceptance, for ordinarily his credit standing would not be strong enough to induce the seller to part with his goods, but the latter is now more willing to take this step, since he is able to draw a draft on a bank. This institution, in creating acceptance credits conforming to the principles described above, is assuming a comparatively small risk. Although the bank obligates itself to meet the accepted draft at maturity, at the same time it holds a counter claim upon the buyer of the goods and, furthermore, a lien upon the goods themselves. Finally, since the bill is thus the direct obligation of a banking institution and at the same time is collateraled by goods and is further covered by the ultimate proceeds of a completed business transaction, it may serve as a highly attractive form of investment for the holder of liquid funds.

These advantages, and in addition a number of others, are claimed by the supporters of the acceptance, but it must be clearly kept in mind that the

instrument possesses these favorable attributes only when drawn in accordance with the concepts of sound practice as developed over many years of banking experience. Several years ago a movement was initiated to change the commercial credit system prevailing in the United States by replacing the promissory note with the acceptance. A study of acceptances in domestic and in addition foreign business would here be irrelevant, and analysis will be made only of "salt water" bills, or those drawn by banks in financing foreign trade. In this field rather than in domestic business, the banker's acceptance has both in European countries as well as in the United States attained its best use, and according to some authorities its only legitimate use. In recent years, a mass of literature has been produced on the subject, but such writings have to a large extent been frankly propagandist in nature, although directed to the laudatory aim of improving the country's credit system and introducing an instrument whose nature was unknown to American banking and business. This literature, although poured out in an unending stream by academicians and bank officers, is usually either abstractly "scientific" or meticulously descriptive. This chapter will attempt a critical consideration of the several forms of banker's acceptances used in foreign trade financing, the technical procedure of handling the bills, and at the same time the extent to which they con-

form to or depart from the principles of sound acceptance practice.

The bills will be considered in the order indicated by the following table:

Classes of Banker's Acceptances

	SECURED	UNSECURED
	Commercial	
Under letters of credit	Documented	Clean
Under acceptance agreements { Single { Syndicate	Secured by: Shipping documents Open accounts Drafts for collection	Accommodation bills Exchange bills
	Investment	
Finance bills	Collateraled	Unsecured

ACCEPTANCES UNDER LETTER OF CREDIT

While the letter of credit is a method of placing the financial burden upon the importer, from the standpoint of the bank on which the drafts are drawn the transactions may cover either an importation or an exportation of goods. Thus, an importer in the United States may induce a New York bank to issue its letter of credit in favor of a Brazilian

coffee exporter, who draws his draft on the bank, and so it is financing an importation to the United States. The same bank may also be called upon to finance an exportation from the United States. Suppose an American exporter selling grain to Germany insists upon payment in dollars. The German importer, through his bank, must then have the latter's American correspondent issue its letter of credit to the exporter. The draft, which he in consequence draws upon the bank, is thus based on an export transaction.

The import and export transactions described above are both examples of direct financing, since they are being carried by an American bank and involve the movement of goods to and from the United States. Indirect financing arises when an American bank accepts drafts covering a shipment between two foreign countries, as the forwarding of coffee from Brazil to Germany. In the period before the war, the greater part of such indirect financing was performed by the sterling bill, and so London supplied the credit for countless shipments which never touched Great Britain's shores.

When a bank issues its letter of credit, whether for an import or export transaction, direct or indirect financing, it is essential for the issuing institution to obtain from the importer a signed contract known as letter of credit agreement, in which the latter agrees to place the bank in funds before the

maturity of the drafts which it accepts. Furthermore, the importer recognizes the bank's title to the imported goods which must be adequately protected against loss.

When a contract of this nature is signed by a reliable importer and when its provisions are fully observed, the bank in issuing its letter of credit is carrying a relatively small element of risk. The drafts which it accepts are self-liquidating since they are based upon a bona fide purchase of goods, and are secured by documents such as either bills of lading, warehouse receipts, or trust receipts until reimbursement is made by the importer.

As to reimbursement, either one of two policies may be followed by the bank. It may allow the importer full possession of the goods to be disposed of in any way he chooses, provided only that he place the bank in funds in time to anticipate the maturity of its acceptances. On the other hand, the bank may require the importer to turn over the proceeds of all sales as they are effected. This policy of prepayment, or rather anticipatory payment, is highly desirable from the standpoint of the bank. Instead of the proceeds of the sales remaining with the importer, and so giving him an opportunity to devote them to his own use, these funds are applied directly to the reduction of his obligations to the bank. Thus, it is more certain of reimbursement and its acceptances are more self-liquidating in nature.

As the advantage of such an amortization scheme lies almost entirely with the bank, it must offer the customer some inducement to make anticipatory payment. The customer forfeits the use of the money between the time of prepayment and that of mandatory payment when the draft of the bank matures. It is, therefore, the practice to allow customers a rebate of interest covering this interval. The rate of allowance is calculated in various ways. The funds thus surrendered to the bank may be considered in the light of demand deposits left with the bank, and so the same rate of interest may be granted. A more accurate method, and the one used in London, is to set the rebate at one per cent below the rediscount rate quoted by the central bank for prime banker's bills. American banks generally permit their customers to withhold reimbursement until the maturity of their obligations, while British and Continental banks usually insist upon prepayment.

When a bank gives the importer shipping documents or warehouse receipts, the period of their release should not be unduly long. In the hands of an unscrupulous person these documents may be rehypothecated with another bank which may extend credit on such pledges. Such action necessarily impairs the security underlying the drafts accepted by the original bank.

There can be little doubt about the value of an

acceptance drawn under a letter of credit and a properly framed credit agreement which provides for adequate protection as outlined above.

ACCEPTANCES UNDER AGREEMENTS PLEDGING COMMERCIAL SECURITY

The greater number of acceptances are not drawn under the letter of credit. These bills are, however, usually based upon some form of agreement which governs the credit relations between the merchant as drawer and the bank as drawee. This document is known as an acceptance agreement and is quite similar in content to the contract for a letter of credit. A typical form is given below:

ACCEPTANCE AGREEMENT

(Arising out of importation or exportation of goods.)

THE X BANK,
Boston, Mass.

Dear Sirs:

We have this day drawn on you our draft(s) numbereddated payableto the order of.....for a total of.....dollars (\$.....) which please accept under the usual terms. In consideration of your accepting the same we jointly and severally promise to provide you in Boston or New York sufficient funds in cash one day previous to the maturity thereof to meet payment of the same with.....per

cent commission together with interest at the prevailing rate where chargeable and sundry charges.

The said draft(s) grow out of transactions involving the importation or exportation of goods, and documents securing title to said goods are attached thereto or are deposited herewith and transferred and assigned hereby to THE X BANK OF BOSTON, hereafter called "The Bank," as per particulars stated below:

PARTICULARS.

AMOUNTS.

We agree to furnish and deposit hereunder on demand such additional security as the Bank may from time to time require, should the market value of said goods suffer any decline in the opinion of the President or Cashier of the Bank. We further agree that the documents attached to said draft(s) or deposited herewith and any other security deposited in substitution therefor or in addition thereto shall be held by the Bank as security for the payment of said draft(s) at maturity, and the performance of all other obligations hereunder as well as for the payment of any other direct or indirect liability of the undersigned to the Bank due or to become due or which may hereafter be contracted, and we hereby authorize the said Bank or its assigns to take possession and sell or otherwise dispose of said goods, security substituted therefor or any addition thereto at its discretion for its reimbursement at public or private sale without demand, notice or advertisement on the non-performance of any of the promises herein contained, and said Bank or its assigns may purchase at such sale on its own account and no other purchaser shall be responsible for the application of the purchase money, and the net proceeds of such sale after paying all expenses thereof, including commission for sale and guaranty and paying all sums whether then or thereafter payable due from the undersigned to the

Bank on account of said acceptance or acceptances or under any other liability, shall be returned to the undersigned.

It is further agreed that any moneys or properties at any time in possession of the Bank belonging to any of the parties liable hereon to said Bank, and any deposits, balance of deposits or other sums at any time credited by or due from said Bank to any of said parties shall at all times be at the option of the Bank held and treated as collateral security for the payment of any obligation hereunder or any other liability of the undersigned, or any of the parties hereto to said Bank whether due or not due, and said Bank may at any time at its option set off the amount due or to become due hereon, or on any other obligation against any claim of any of said parties against said Bank.

In the event of any suspension, failure, assignment for the benefit of creditors, or bankruptcy of the undersigned or any of them, or the non-fulfillment of any obligation hereunder on our part to be performed, all obligations and liabilities to said Bank on our part shall thereupon, at the option of the Bank, then or thereafter exercised, without demand or notice, mature and become due and payable.

We hereby assume all responsibility for, and said obligation to place said Bank in funds shall not be affected or impaired by, any error or delay in the transmission of telegrams or cablegrams, or the loss of letters or other documents in transmission which may be sent in connection with said drafts or bills for collection.

It is further understood and agreed that the Bank shall not be held responsible for the correctness or validity of the documents representing shipment or shipments nor for the description, quantities, quality or value of the merchandise declared therein, nor for any delay or deviation from instructions in regard to shipments.

This obligation shall continue in force and be applicable to all transactions notwithstanding any change in the composition of the firm or firms, parties to this contract, whether such change shall arise from the accession of one or more new

partners, or from the death or secession of any partner or partners.

All rights arising under this agreement shall be determined according to the laws of the Commonwealth of Massachusetts.

.....

ILLUSTRATION 21

Under this instrument the exporter is permitted to draw a draft upon the bank, provided he pledges certain collateral. The amount of these bills is of course less than the value of the security by possibly twenty or thirty per cent. This difference or margin is governed by such factors as the reliability of the drawer and the marketability of the accompanying goods.

The nature of the collateral hypothecated by an exporter depends to a large extent upon his selling methods which may be either on an open account basis or settlement by drafts drawn upon the importer. Either of these may serve as security for the draft drawn by the exporter on his bank. The banker's acceptance thus created provides the exporter with so much credit and thus becomes the means of financing his shipment. However, the liquidity and the security of such an acceptance may be open to question.

Where the collateral consists simply of open accounts, the intimate relation between the acceptance and a specific business transaction is lost and

the assurance of payment by the importer becomes quite indefinite.

REFINANCING ACCEPTANCES

Where the collateral consists of drafts drawn upon the importer and lodged with the bank for collection, its acceptance creates what is known as a "refinancing" credit. The customer first signs an acceptance agreement which is similar in content to the form given above, with the exception that it contains the following opening statement addressed by the exporter to the bank:

"In consideration of your acceptance of my draft drawn on you against my foreign collections as security as follows:

My draft No.
drawee
commodity

amount

I hereby unconditionally guarantee the payment of such draft [the refinancing acceptance] at its maturity."

The operation of a refinancing credit as described on page 294 involves, first, the drawing of a documentary draft by the exporter on the importer, and secondly a clean bill drawn on the bank and called a "substitute" or a "refinancing" acceptance. The first draft is sent to the importer for payment and the proceeds are applied to anticipate the maturity of the bill drawn on the bank.

This acceptance can be sold by the exporter who

thereby obtains his money from the transaction immediately, instead of being forced to wait until payment is later made by the importer.

This form of security is far more satisfactory than a pledge of merely an open account, since the former is more directly related to a specific business transaction. Hence the refinancing acceptance is a sound instrument if based on one or more bills drawn as a result of bona fide purchases of goods.

It is, however, a misuse of the acceptance privilege when the goods are not actually sold but shipped on consignment and so provide no assurance of payment to anticipate the maturity of the draft drawn on the bank.

This type of acceptance is widely used in facilitating exports to the Continent where importers, because of depreciated currencies, find difficulty in financing themselves. For example, an American exporter will ship cotton on consignment to his representative in Bremen. He offers this consignment as security to a New York bank which permits him to draw a 90-day draft. The bank obtains possession of the bills of lading which are forwarded to a German correspondent. The latter delivers these shipping documents to the agent of the exporter in order to enter the goods which are then warehoused and the warehouse receipts returned to the correspondent of the New York bank. It surrenders these warehouse receipts to the agent of

the exporter as he makes sales of cotton to German spinners.

The proceeds are then credited to the account of the New York bank which applies these sums to anticipate the maturity of its acceptance. Thus the exporter and his bank bear the financial burden of financing the goods to the market of the buyer who because of his impaired credit can not assume this task and who is compelled to buy on a virtual "hand to mouth" basis. However necessary this form of banker's acceptance may be, it is not based on a specific purchase of goods and so it is lacking in liquidity.

ACCEPTANCES UNDER SYNDICATE AGREEMENTS

About the least understood, and at the same time, the most discussed type of bill, is the acceptance created under a syndicate agreement. During the war and post-war periods, this instrument was the means of financing exports worth many millions of dollars. The plan was originated during the war to enable American banks to finance the enormous exports to the Allied nations. The first syndicate acceptance, amounting to \$25,000,000, was managed by Brown Brothers acting on behalf of the French government. Among other important syndicate credits were the financing of the Cuban sugar crop in 1917, the American tobacco syndicate of 1918, and the Belgian reconstruction credit of 1919.

While the various types of acceptances usually involve the extending of credit by only one lender, the syndicate acceptance enables credit to be granted by a group of lenders. This principle of multiple lending has long been applied in distributing both commercial and investment paper in the United States. The motive in including a group of lenders arises from the fact that the desired accommodation is too large to be granted by a single party. Promissory notes of large borrowers, such as meat packers and steel manufacturers, are sold by note brokerage houses to banks, business houses, and private individuals having surplus funds. In the investment business it is the practice to market securities through a syndicate of banks composed of a manager and a group of associates.

The operation of the syndicate acceptance plan follows in general the methods which have been developed in the marketing of either notes or securities. First a bank is appointed as syndicate manager to administer the entire transaction. The next step in the operation of a syndicate acceptance is for the managing bank to have the beneficiary of the credit sign an acceptance agreement similar in general content to the ordinary acceptance agreement described above. The details vary with the monetary importance of the transaction, and so the agreement may be drawn on a standard form of a single sheet, but in the case of involved dealings a good-sized booklet

somewhat like the indenture of a corporate mortgage is required. These agreements are carefully formulated by the senior officers and the attorneys of the managing bank.

The agreement specifies all the conditions of the syndicate and in particular defines the nature of the underlying security which may include a margin of from ten to twenty-five per cent. This collateral may be lodged with the syndicate manager, or with another bank acting as custodian.

After the agreement has been executed or even while it is still being considered, the syndicate manager invites other banks to participate in the credit. These institutions are informed of the general terms of the agreement and, if satisfactory, an application to participate is sent to the syndicate manager. These applications are limited to minimum amounts, which in some instances have been placed at \$100,000. While each participating bank agrees to accept up to this sum, the drafts are drawn in small denominations of, say, \$5,000 or \$10,000 to insure better marketability. The beneficiary of the credit may be an American exporter or a foreign importer. In either case the beneficiary of the credit draws his draft upon the participating bank designated by the syndicate manager, and at the same time delivers it together with the shipping documents or other forms of security to the latter. If upon examination they prove satisfactory, the managing bank presents

the draft direct to the participating institution for its acceptance and also for payment. In the case of an inland bank, it is represented by its New York correspondent which makes payment to the syndicate. The draft may be held or marketed by the accepting bank, but more usually it will return the acceptance to the syndicate managing institution which will sell the acceptance in the open market at the current rate of interest. The proceeds of such a sale are then given for the account of the borrower to the accepting bank, which thereby carries a profit or a loss, depending upon whether the amount of the sale was above or below the sum of the acceptance after allowing for the interest and other charges. At times the accepting bank located in the interior and with a limited credit standing may encounter difficulty in marketing its bills at a favorable rate, and so they are endorsed by a better known institution.

The compensation depends upon such factors as the degree of the risk, the nature of the collateral, and the duration of the credit. Accordingly the allowance to the participants may range from 1 to 2 per cent per annum, and the commission to the syndicate manager from $1/8$ to 1%.

The syndicate acceptance arrangement offers certain advantages to the various parties involved. For big borrowers it makes possible the financing of large-scale operations. Such dealings can easily

be handled by British or Continental banks which control enormous resources because of the branch system and the concentration movement in these countries. However, in the United States where the system of small unit, independent banking still prevails, the syndicate acceptance makes it possible for American banks to undertake large credits. The risks, too extensive for one bank to assume, are thus spread among a group of institutions. The syndicate plan also saves much time and expense, especially in financing a number of transactions of the same kind.

Concerning the soundness of the acceptance drawn under a syndicate agreement, the same comments may be made as were applied above to the acceptance created under the single agreement.

ACCEPTANCES COLLATERALED BY NON-COMMERCIAL SECURITY

The acceptances described above, whether created to finance import or export transactions, or whether drawn under letters of credit or acceptance agreements, were all based on some security of a commercial nature. This collateral may consist either of shipping documents evidencing goods in transit or warehouse receipts representing goods in storage, since the acceptances are created fundamentally to finance the marketing of goods from producers to consumers. This is essentially the function of a commercial bank and its acceptances when drawn

for this purpose may properly be termed commercial bills.

Acceptances may, however, be used to facilitate non-commercial transactions, and so the instruments are then described as "finance" bills or sometimes "loan" bills.

An endless and often useless controversy has been conducted over the finance bill owing to loose definitions. The expression "finance bill" is frequently extended to include also exchange and accommodation bills as described below. It would avoid considerable confusion if the term "finance bill" were limited in its application only to a draft, secured or unsecured, drawn to extend credit facilities for the carrying of a non-commercial transaction.¹

These acceptances may be drawn to cover either domestic or foreign business transactions. In those European money centers where stock exchanges are operated, it is customary to obtain loans by drawing drafts on banks and offering stocks and bonds as collateral. In New York, stock exchange brokers similarly receive advances from their banks, but instead of an acceptance the ordinary promissory note is signed. In recent years there has been a considerable agitation favoring the employment of the acceptance in financing stock exchange dealings.

¹ For other views, see Escher, *Foreign Exchange (Part II of Banking Practice and Foreign Exchange)*, pp. 321-322; Patterson, *Domestic and Foreign Exchange*, p. 144; Whitaker, *Foreign Exchange*, p. 380.

This use of the acceptance is purely local in nature, and the issues involved need not be considered here. The finance bill also arises in international transactions. It is drawn by a bank in one country on a financial firm in a second and is used to facilitate the movement of credit between various money centers. Capital naturally flows to that place where it can yield the largest return, and so in pre-war days loan bills were created for this purpose. They were drawn, as described by Mr. Paul M. Warburg (*National Monetary Commission Report*, Vol. XX, p. 12), "to profit by the difference between the interest rate in the country where the bill was issued and the discount rate in the country in which the bill was drawn." Before 1914, these bills were usually drawn by banks in the United States or in Russia where the prevailing interest rates were high, and were accepted by financial firms in England or in France where ruling rates were lower.

During the war, the volume of finance paper was reduced, as such acceptances were discouraged by the belligerent governments. These financial policies were adopted to conserve credit for strictly essential war needs by limiting the amount of credit available for speculation on the local stock exchanges and also by preventing the outflow of capital from the country. Since the close of the war, finance bills have again made their appearance but such drawings have been confined to countries such as Switzerland and

Holland, whose capital resources have not been exhausted and whose ruling rate of interest is lower than that of the former belligerents.

The worth of finance paper has always been open to question. Especially doubtful is the value of the domestic finance bill, used solely for stock exchange speculation and based frequently on undigested or unsold securities. For this reason, conservative banks are unwilling to accept bills drawn for such purposes.

In testifying for the National Monetary Commission, Sir Felix Schuster, then Governor of the Union of London and Smith's Bank, was asked "whether there was a discrimination between a merchandise, a trade bill, and a finance bill in times of easy money rates." In reply, he made the following statement:

"When you are dealing with bank bills, such as our acceptances or those of other first-class banks in London, there would be no discrimination, but when you come to financial houses there is a discrimination, and the ordinary genuine trade bill is very much preferred, and it would not be safe for any firm, however strong, to disregard that feeling, and people for their own protection would not care to accept a purely finance bill. We try to discriminate in the business. We do an accepting business, but when we think the bill is drawn purely for finance reasons, such as stock exchange speculations, we do not care for the business; we decline. Our acceptances are only £4,000,000. If we choose to go in for accepting finance bills, that might be five times the amount very easily." — *National Monetary Commission*. Interviews on Banking in England, France, Germany, Switzerland and Italy.

Central banks uniformly refuse to discount or purchase finance paper because of its obvious illiquidity.

This hostility is not so pronounced against foreign finance bills especially when drawn by a bank of good standing on a second institution of similar position and also independent of the first. Paper thus bearing two good names and collateraled by adequate and sound security may certainly be regarded as secured. It is, however, based upon a non-commercial transaction and therefore does not possess the liquidity of a strictly commercial bill.

UNSECURED ACCEPTANCES

The several types of bills thus far described have been collateraled by some form of security whether commercial or non-commercial in nature. Clean bills, unsupported by any form of security, may also be drawn for the creation of either commercial or investment credit.

ACCEPTANCES UNDER CLEAN LETTERS OF CREDIT

A clean letter of credit permits the beneficiary to draw drafts without delivering shipping documents or any other evidence of the existence of goods. While the clean letter of credit may quite possibly be based upon an actual import or export transaction, it does not on its face bear evidence of this fact. Consequently there is no assurance that the acceptances are secured by actual merchandise or that their payment will be anticipated by the settlement of an underlying business transaction. Clean letters of credit, therefore, give rise to drafts

which are questionable, both as to their security and their self-liquidating character.

ACCOMMODATION ACCEPTANCES

Most unsecured acceptances are not drawn in connection with letters of credit, but are authorized under some form of acceptance agreement between drawer and drawee. Such clean bills are really forms of accommodation paper and represent an advance not based on any tangible security but resting on solely the credit standing of the borrower. They are usually drawn in anticipation of an import or export of goods. For example, an American importer wishes to extend credit to a foreign exporter in advance of the actual shipment. The bank may agree to accept a draft drawn by the American merchant. Conversely, an American exporter who can show sales contracts for goods destined for a country outside of the United States may obtain acceptance facilities for the financing of the transaction even before the goods are ready for export. In both cases the bank will later receive the bills of lading when they are eventually forwarded. This type of acceptance is sometimes described as a finance bill, but wrongly so, since it is after all drawn for commercial purposes. True, no shipping documents are attached to the bill and so there is no way of determining whether it is actually tied to a specific transaction.

On the value of the undocumented or clean bill, there is a division of opinion. The British joint stock banks have steadfastly insisted upon collateral in the form of commodities with a margin of from ten to twenty per cent, and have refused to extend "open" or "uncovered" credits. This business has been left largely to the private banking firms and acceptance houses of London. The French and other Continental banks have been willing to accept bills not based upon specific business transactions, but merely upon the general credit standing of the borrower. Thus, while British banks in granting acceptance facilities rely for their reimbursement upon documents, the European institutions direct their attention to the names on the bills. In other words, the test of security in England is capital, while on the Continent, it is character.

EXCHANGE BILLS

An interesting form of unsecured paper is the acceptance drawn to supply exchange as a means of settling business transactions between two countries. These exchange acceptances are not needed in the trade relations between countries, such as the United States and Great Britain, where mail communication is frequent, the foreign exchange market broad, the banking system developed, and, most important of all, exports are varied in nature and so continuous throughout the year. The

use of such exchange drafts is justified in trading with countries having irregular mail service, limited foreign exchange market, undeveloped banking system, and exports of a seasonal character. Under these conditions, in such countries there are times throughout the year when exports will not pay for imports, when importers are consequently unable to obtain sufficient foreign exchange to pay for the goods purchased abroad, and when their currency sells at an unfavorable rate. Before 1914, these conditions applied in a limited degree even to the United States whose exports of grain and cotton were concentrated largely in the fall and whose foreign purchases were made throughout the entire year. This state of foreign trade still prevails among certain Central and South American countries which are largely dependent upon one export, such as nitrate in the case of Chile, sugar from Cuba, or coffee from Brazil. Under these conditions the problem is to supply the importers in these countries with sufficient credits, until the time of the year when exports are sufficient to provide payment for previous purchases. This end is accomplished by permitting the banks of the weaker countries to draw bills with a maturity of from three to six months upon financial houses in countries of greater financial strength.

While these acceptances are undoubtedly commercial bills, they are neither self-secured nor self-liquidating. They are based on no particular

transaction but are drawn only in anticipation of exports in general. It is sometimes argued that commodities such as Brazilian coffee or Cuban sugar cannot be consumed in the producing country and so must of necessity be exported and sold abroad. In reply it can be urged that there is no absolute assurance that these exports will find a ready market, as witnessed by the crisis of 1920 when coffee and sugar fell to a fraction of their former values.

Thus, although exchange bills are necessary for the financing of trade between countries in different stages of economic development, such acceptances must be regarded as unsecured advances and therefore should be created with the utmost caution.

Because of its lack of security and its dissociation from a specific commercial transaction, the exchange acceptance is classed as a finance bill by some authorities. Where, however, the bill is used in the manner described above, despite obvious weaknesses it remains commercial in nature and becomes a finance bill only when it is employed to supply credit for the speculative carrying of foreign securities.

It has been seriously suggested by certain American and European bankers that acceptances of this type shall be used to stabilize the exchanges of the Continental countries with depreciated currencies. The plan calls for the drawing of bills by foreign banks on American financial institutions which could

receive a guaranty of reimbursement from the central banks or the treasuries of the foreign countries. Little argument for or against the proposal can be drawn from the experience of the past. Unfortunately no accurate study has thus far been made showing whether or not exchange bills have succeeded in stabilizing rates between countries of strong and weak currencies.

UNSECURED FINANCE BILLS

The weakest form of acceptance paper is the unsecured finance bill. It is supported by no tangible collateral, and furthermore, since the underlying transaction is a long-term operation, its duration does not coincide with the life of the acceptance which is adapted only for a short-term credit extension. Because of this discrepancy, the accepting bank has little assurance that it will receive reimbursement in time to anticipate the correlative obligations which it has assumed. Inability to reimburse the client as the taker of the credit may thus bring embarrassment to the accepting bank. Such a situation arose in 1890 when Baring Brothers, one of the outstanding private banking firms of London, accepted drafts drawn by the Argentine Government. But the latter was unable to provide the funds when the bills matured and as a result the acceptor was forced into temporary bankruptcy.

The value of the unsecured finance bill also came

into question during the war when New York financial houses were considering the granting of a loan to the Russian government. This advance was to be granted by means of a bill drawn by the Russian ambassador on several American banks. The security offered was the taxing power of the borrowing government. But the proposal was finally abandoned as the transaction was regarded as illiquid and the acceptance as possessing no more force than an ordinary single-name promissory note.

GOVERNMENT REGULATION OF ACCEPTANCE POWERS

In considering the various classes of acceptances, it has so far been assumed that the banks are free in shaping their policies, but in the United States these must conform to certain rules as fixed by the government. Regulation in general of the banking business is justified because of its semi-public nature, for, by controlling credit power the welfare of all other enterprises is vitally affected. Furthermore, in the United States with its independent system of 30,000 banks government regulation is necessary to attain some measure of uniformity in operation. This aim has been especially marked in developing a discount market for acceptances. In order that dealings in these instruments may be facilitated, they must conform to certain general standards as in the case of any other commodity

such as wheat or cotton. A further reason for government regulation of the acceptance lies in the fact that this form of paper for many years was misused and has only recently been reintroduced. Hence the need of establishing certain general rules for banks to guide them in a new field of operation.

The American banking system is under dual governmental regulation, because of the existence of both state and national banking laws. The state regulations on acceptances vary considerably and are summarized in Appendix No. IV. Under the National Bank Act, which for half a century before 1914 governed the operations of federal incorporated financial institutions, they were not authorized to accept drafts. Since they were thus deprived of this essential power in financing foreign trade, which is conducted largely by means of the bill of exchange, American banks had to arrange for acceptance credits through correspondents abroad, especially in London. With the growing need of direct foreign trade financing, efforts were made before 1914 to confer the necessary acceptance power upon American banks. The Comptroller of the Currency rendered a favorable ruling on this matter, but his opinion was not sufficiently definite to encourage banks to proceed very far. The bill proposed by the National Monetary Commission, known as the Aldrich Act, made provision for the acceptance, but it remained for the Federal Reserve

Act to reintroduce this form of commercial paper into the American financial system.

In creating acceptances banks which are members of the federal reserve system must observe certain general conditions specified in the Act. These in turn are applied by the Federal Reserve Board which from time to time issues rulings to govern acceptance practice. Besides, the legal department of the Board also expresses opinions interpreting questions raised by banks seeking guidance in their operations. The opinions of counsel are not final since they may be superseded by the rulings of the Board, but at all times this body must follow the statutory provisions of the Act. Thus acceptance powers of banks are regulated by opinions of counsel, rulings of the Board, and provisions of the Federal Reserve Act.

This system of regulation has in some respects been drastic, but in general it has been framed so as to conform to the best acceptance principles developed abroad and outlined in the beginning of this chapter. Of late years there was a growing feeling among the banks that strict government regulation had accomplished its end, and was no longer necessary. This view was advanced by the American Acceptance Council representing the larger accepting banks. It was generally felt throughout the country that the accumulating of rule upon rule, and opinion upon opinion had become so compli-

cated that they could not well be followed and so a simpler system was needed. The Federal Reserve Board in 1922 issued a new set of regulations superseding all previous promulgations. As a result the policy of the Board was completely reversed. Where formerly it had retained supervision over the quality of acceptance paper created by member banks, this oversight was now delegated to the various Federal Reserve Banks which were thus authorized to pass on the eligibility of bills of exchange accepted by the banks within their respective districts.

Under regulation C of 1923 (see Appendix No. III), banks in the Federal Reserve system may finance domestic and foreign trade through acceptances covering domestic shipments, warehoused goods, import transactions, export transactions, and dollar exchange operations. In every case the acceptance must be based on "a readily marketable staple," which has been defined by the Board as "an article of commerce, agriculture or industry of such use as to make it the subject of constant dealings in ready markets with such frequent quotations of price as to make (a) the price easily and definitely ascertainable and (b) the staple itself easy to realize upon by sale at any time." Also the bill of exchange must, according to the Act, be "drawn in good faith against actually existing values," which expression requires that the acceptance must represent an actual business transaction whereby the title to the underlying goods has

been really transferred from seller to buyer and not merely to an agent of the former. Proof of the existence of the goods underlying the acceptance is of course indicated in the accompanying shipping documents, warehouse receipts or trust receipts. The Act also limits the extent to which banks may assume acceptance liabilities. These are summarized in Willis and Edwards, *Banking and Business* (pages 146-147), as follows:

“A national bank may accept on behalf of its customers bills of exchange to a total value of 50% of its capital and surplus. This power to accept drafts may be augmented to 100% of the capital and surplus of the bank if the petition for this privilege is granted by the Federal Reserve Board. A bank may accept drafts arising out of foreign transactions as well as domestic trade. While a total of these foreign acceptances may possibly equal 100% of its capital and surplus, or its maximum acceptance liability, in no event may the domestic bills of exchange amount to more than 50%. Acceptances based on foreign transactions may have a maturity of six months, but those growing out of domestic business may not run longer than three months. Banks engaged in international trade financing may accept drafts to create dollar exchange in certain foreign countries, provided that the aggregate of the additional drafts does not exceed 50% of their combined capital and surplus, and they do not have a maturity of longer than three months, or one-fourth of a year. Thus a bank with a combined capital and surplus of \$1,000,000 may incur a total acceptance liability of \$1,500,000 constituted as follows: (1) \$500,000 on acceptances arising out of domestic transactions, (2) \$500,000 growing out of foreign transactions, and (3) \$500,000 on acceptances drawn to create dollar exchange. Also 1 and 2 may be combined so that the total of foreign acceptances will amount to \$1,000,000, or 100% of the bank's capital and surplus.”

CHAPTER XIV

THE DISCOUNT MARKET

MEANING OF THE DISCOUNT MARKET

The previous chapter on bank policy has considered the subject of credit policy from the viewpoint of the individual institution. In actual practice these banks in testing, comparing and offsetting claims to wealth, function not individually but collectively. Such institutions when operating in close relation with one another constitute what is known as the financial market. It may be divided into, first the investment market which deals in long-term obligations issued to capitalize undertakings of a more permanent nature, and second the discount market which is concerned with short-term paper created by banks and commercial firms to finance ordinary business transactions. This chapter will be confined to a survey of the short-term or discount market in Great Britain and the United States from a functional rather than a purely descriptive viewpoint.

FUNCTION

The discount market in any country is the mechanism for dealing in claims to current funds offered by

sellers with surplus assets and demanded by buyers in need of such accommodation. The discount market thus enables sellers to invest their funds at a profit and buyers to obtain short-term credit at a reasonable rate. In each country there is a central discount market in which under normal economic conditions large dealings can be negotiated without any serious disturbance to rates and where in turn the rates or the cost of money for the entire country may be regulated and kept at a relative equality.

The claims dealt in the discount market may be collateraled by stocks or bonds, or may be secured by specific business transactions, either domestic or international in scope. Moreover, these claims may be drawn in the form of notes or of bills. Attention will be confined to that part of the discount market which is concerned with claims based on strictly commercial transactions arising out of international dealings and drawn in the form of bills. The bill or acceptance market in London and on the Continent is the most important element of the entire discount market, while in New York it still remains of minor significance.

The reasons for the pre-eminence of the London market in international finance may be enumerated as follows:

(a) The London discount market offers the best facilities for turning bills of exchange into cash, a fact

which has induced banks and acceptance houses to sell more freely their credit, and merchants to buy acceptances, since both groups know that there is a steady demand or supply of these bills.

(b) The volume of Great Britain's sea-borne trade is very great, and the fact that British overseas and colonial banks have branches and agencies all over the world willing to buy or discount sterling bills, have made sterling bills a most liquid paper.

(c) There is always available in London a comparatively large volume of fluid funds which seeks investment in short-term liquid bills even at comparatively low rates of interest.

(d) British banking legislation imposes no restriction upon the banks as regards the amount of bills they may accept. British banks are in this respect, therefore, guided entirely by the judgment of their officers and directors, whereas American institutions must observe carefully the limitations described in the previous chapter.

ELEMENTS IN THE LONDON MARKET

The complementary factors in the London discount market are the acceptors who create the bills, the investors who buy them, the Bank of England which stabilizes money rates and the middlemen who facilitate purchases and sales. Specifically the accepting institutions include besides regular acceptance houses, the private banks, joint stock

banks, overseas banks, and branches of foreign banks. These institutions enter the discount market at the same time as buyers and sellers of bills. The acceptance houses of London developed from old merchant firms who for a commission accepted drafts on behalf of importers with credit standing less known by the foreign sellers. The more important of these acceptance houses are Henry Schroeder & Co., Ralli Brothers, Kleinwort Sons & Co., Hambro & Son, and Frederick Huth Co. The leading private bankers are Baring Brothers, Brown Shipley & Co., Morgan Grenfell, Speyer, Rothschild, Samuel Montagu, and Coutts. The joint stock banks include the Big Five or Barclay's, London Joint City and Midland, Lloyd's, National Provincial and Union, and the Parrs Westminster Banks. In addition there are also smaller joint stock institutions organized under the laws of England and Wales, the Irish Banks such as the Bank of Ireland, and the Scottish banks, of which the largest is the Commercial Bank of Scotland. Bills are accepted and also both bought and sold by overseas banks which have been described in Chapter V, pp. 138-139. The Bank of England acts as the stabilizer of the discount market. Attention will here be given to a detailed analysis of the discount houses and bill brokers who, as middlemen, facilitate the purchase and sale of bills in the market.

ORGANIZATION OF DISCOUNT HOUSES

A bill broker is essentially a middleman or intermediary who facilitates the purchase or the sale of bills of exchange. When the bill broker is associated with others in the same business the concern may then be described as a discount house. Bill brokers and discount houses are also described as "discount agents."

A discount house may be organized as a private firm or as a limited company which in turn may be private or public. The National Monetary Commission Report indicated that in 1910 there were about twenty private firms and two limited companies engaged in the business of handling bills, while at present there are fifteen private firms, three limited public companies and two limited private companies. This trend toward incorporation is well illustrated by the history of Alexanders Discount Company. Originally founded in 1810, by Mr. William Alexander, the firm was reconstituted in 1891 as a private limited company, and since 1912 has operated as a public company (*Statist*, May 20, 1922, p. 811). The paid-up capital of this corporation remained fixed at £500,000 from 1910 until 1920 when it was increased to £550,000, and in 1922 it was further augmented to £600,000, the increase of £50,000 representing the capitalization of £50,000 of undivided profits. At the

same time the reserve fund of the company increased from £60,000 in 1910 to £320,000 in 1921. In 1922 the authorized capital was increased from £600,000 to £1,250,000 by the addition of 25,000 ordinary shares of £10 each.

The National Discount Company was incorporated in 1856 under the Joint Stock Companies Act. The capitalization of the company has remained quite stationary in recent years. The paid-up capital stood at £846,665 from 1910 until 1922, but within the same period the reserve fund advanced from £450,000 to £500,000 (*Ibid.*, p. 865).

The Union Discount Company of London is the largest institution of its kind in the world. Within the past decade its capitalization has been considerably increased. Its paid-up capital rose £750,000 to £1,000,000 in 1919, but since then it has remained unchanged. The reserve fund of the company likewise moved from £600,000 in 1910 to £1,000,000 in 1919, and on December 31, 1921, an additional £100,000 were added from the profits of the current year. The Union Discount Company's statement shows also a provisional reserve fund which has risen from £71,928 to £154,609 in 1921 (*Ibid.*, p. 885).

In addition to these three public limited discount companies there are also two private limited companies. Baker, Duncomb & Co. was formed as a limited company in 1905. From 1910 to 1921 paid-

up capital remained stationary at £100,000 until 1921 when it was increased to £200,000. Reserve funds declined from £90,000 in 1921 to £35,000 in 1922 (*Ibid.*, p. 812). Another limited company of about the same size is Cater & Co.

The public and the private limited discount companies differ in that the shares of the former are held by the general investing public, while the shares of the latter are owned by a small group. The shares of the public discount companies of London are held by a relatively large number of owners, and in this respect differ from the New York Discount Corporation whose stock is carried by a few commercial banks. The distinguishing feature of the public limited company is its ability to receive deposits and hence the power to extend its field of operations beyond that of the limited private companies or the private firms which are dependent solely upon their own capital or upon borrowings from outside sources. (See *Times Trade Supplement*, June 3, 1922, p. 11, col. 3, Shortis, F. R. A. in *American Acceptance Council Bulletin*, June, 1922, p. 6.)

METHOD OF HANDLING BILLS

On the London stock exchange a sharp distinction is drawn between the broker who facilitates the transfer of securities at a commission and the jobber who actually buys and sells the securities for a

profit. In a way the same differentiation is made in the bill market. There are about four "running" brokers who act as intermediaries between buyers and sellers and receive a commission usually $1/16$ per cent of the amount of the bills sold. As these brokers do not "carry" bills they have no need of any capital of their own nor of any loans from the banks. Historically the running broker represents the first stage in the evolution of the discount house. Hartley Withers in his "Meaning of Money" ventured to prophesy a decade ago that the running broker would soon disappear, but he still continues as a small but useful factor in the London bill market of to-day. Of far greater importance is the bill dealer, who possesses capital, can therefore obtain loans and is consequently able to carry or own the bills. These constitute his stock in trade, and so the bill dealer is really a jobber. As he is thus borrowing money in order to purchase the bills, his return arises from the difference in the rate of money borrowed, and the rate on bills carried. Hence the dealer obtains his compensation not in the form of a commission, but in the shape of a profit on capital borrowed from others. These persons are given a remuneration which may be regarded in the economic sense as interest on capital loaned to an entrepreneur who in this case is the bill dealer. This party being in possession of borrowed capital may adopt one of two policies. He may purchase bills and hold them

until their date of maturity, or sell them as quickly as possible. The former policy can well be adopted by the discount company which possesses its own capital in addition to borrowed funds. This same business can also be conducted in a limited way by private firms. Although possessed of small capital, they are able to borrow considerable sums with which substantial blocks of bills can be carried. As the rate of discount remains naturally constant during the life of these bills, and if the rate of borrowed funds declines, such dealers then realize handsome profits. There can never be any assurance that market rates will continue to move uniformly in one direction and so the carrying of bills for any length of time is a business which must necessarily be speculative in nature, for it follows that the extent of profit on any business transaction is proportioned to the extent of its risk. The more conservative dealer is satisfied to find his profit in a rapid turnover of the bills in which he is trading.

LIABILITY FOR BILLS

A further distinction between types of firms engaged in the London market turns on this question of practice whether or not they assume liability for the bills which they sell. Obviously the running broker who, as explained above, does not actually buy bills, never indorses them and so cannot be held respon-

sible. On the other hand, the large discount company with substantial capital resources undertakes full responsibility for all bills which it resells. The majority of private dealers also assume complete liability for the bills which they sell to their customers. As the dealers handle so vast a volume of bills in their daily business, it is practically impossible to express this liability by indorsing each bill; a dealer therefore usually gives his regular customer a standing contract known as a "covering letter" which may read as follows: "With reference to any bills which we may from time to time sell to you, you may consider the same as if endorsed by us; although our name does not appear on them, we hereby undertake to indorse such bills when called upon to do so by you."

It is evident that this contract has the same binding force as the indorsement itself and so the dealer is obligated absolutely to the holder of any bill which is dishonored by the drawee at maturity. This procedure as a matter of fact represents only a polite fiction, for the dealer possesses capital running at best only into the thousands of pounds sterling, while he is assuming liabilities which amount to millions of pounds sterling. It must, however, be remembered that these liabilities are not actual but only contingent, for they are drawn upon acceptors who are usually the most powerful banking institutions of the world. The risk of the indorsing dealer

as primary obligor is thus infinitesimal. Nevertheless, there are some bill dealers who refuse to accept even this risk and do not endorse bills or give their customers covering notes.

DEVELOPMENT OF THE NEW YORK BILL MARKET

The dollar acceptance was instituted in 1914 by the Federal Reserve Act and was developed by the enormous war trade until the first half of 1920, when it seemed as if the dollar acceptance would replace the sterling bill and that New York would replace London as the financial center of the world. Thereafter a sharp reverse set in, and despite the support of the Federal Reserve system, the amount of dollar acceptances outstanding declined steadily, while sterling bills increased, and the London money market little by little resumed its former place. With these points in mind, it of interest to review briefly the development of the American discount market during this entire period, and to survey its relation to the Federal Reserve system, in order to understand better the influences responsible for its growth and the later reaction.

The largest proportion of dollar bills are created in New York, which constitutes the main discount market of the country. The predominant position of New York as the leading discount market within the United States becomes more apparent if one considers that on April 1, 1920, 1921, and 1922, the

acceptances outstanding created by New York banks amounted to \$446,748,184, \$445,933,585, \$279,762,592, or to 67, 67, 56 per cent, respectively, of all the acceptances outstanding in the United States. New York also attracts large amounts of foreign funds from abroad, which to a considerable extent are invested in dollar drafts. It was estimated that in 1921 about \$300,000,000 of foreign funds were so invested in the New York discount market, and with the heavy "flight of capital" from countries with depreciating currency, this amount has probably increased.

There are several reasons for the flow of money to the United States. First, the fact that the United States is at present the great creditor nation to almost all countries of the world makes it desirable for the debtor countries continually to have funds available in New York. Second, the United States is the only country of importance on the gold standard, which makes it possible for creditors at any time to convert into gold their funds held in New York. Third, the high rate of interest prevailing in the New York discount market as compared with London, naturally attracts from all parts of the world surplus funds seeking short-term investments.

Despite favorable financial and economic conditions in the United States and the efforts of the Federal Reserve System to create a steady and sound discount market, bankers' acceptances in the

United States have had only a slow and limited growth, and since 1920 there has been a decline.

REASONS FOR THE WEAKNESS OF THE AMERICAN ACCEPTANCE MARKET

The main reasons for the inability to establish an active acceptance market has been the decrease in foreign trade, the competition of call money loans, of government securities, and of commercial paper.

The decrease in our foreign trade, both in quantity and in value, is one of the important causes for the decline in the volume of dollar acceptances. Since about three-fourths of all acceptances outstanding arise in international commerce, the volume of acceptances must of necessity rise or fall directly with the increase or decrease in foreign trade. There has been an especially close relationship between the size of our imports and the amount of acceptance liabilities of American banks. Thus, for instance, the acceptance liabilities of banks members of the Reserve System reached their peak in May and June, 1920, when they stood at about \$673,000,000, while at the same time imports into the United States reached their maximum of \$552,000,000 for May, and \$537,000,000 for June, 1920. From this date on both acceptances and imports decreased, the former, however, moving more slowly, owing mainly to the fact that New York banks were still financing large quantities of exports.

A second factor in retarding the development of a bill market has been the competition of the call money market which because of its prestige and organization has absorbed by far the larger part of the surplus liquid funds of the country. Contrary to European practice, the call renewal rate in New York is determined not every fortnight but every day, and is the result of the daily demand for and supply of liquid funds. Since the call money market absorbs far more funds than the bill market, the acceptance rate naturally becomes directly dependent upon the call money rate, for if the latter rises sufficiently beyond the rate on acceptances, obviously holders of liquid funds find it more profitable to invest their funds on call loans than in acceptances. While it is true that acceptances are at present also used as collateral against call loans, the rate on such call loans is only one-half of one per cent below the call rate against stock exchange collateral. Therefore, so long as the call money rate secured by acceptances is higher than the acceptance rate, as during 1923, it is not profitable to use such bills as collateral against call loans. Whenever, on the other hand, the acceptance rate is higher than the call money rate secured by acceptances, as during 1922, larger quantities of bills will be pledged as collateral on the call money market.

The call money market also influences the acceptance market in another respect. Most acceptance

dealers do not operate with their own capital but borrow up to about 80 per cent of their holdings from banks on call. The margin between the average yield and the average cost of borrowed money is always very narrow. It is clear, therefore, that at a time when the demand for bills is light, any increase in the rate of call money will quickly wipe out the profit of the dealer and force him to liquidate his bills at any price in order to avoid further losses. Acceptance dealers, therefore, will be able and willing to expand their purchases, and thereby offer a ready outlet for acceptances only, in proportion as they feel assured of obtaining an adequate amount of credit at rates which will enable them to earn sufficient profit.

Government bonds and certificates of indebtedness have also hampered the free development of the acceptance market in the United States. These securities with their tax-exempt features have to a large degree determined the level of interest below which the rate on bankers' acceptances cannot fall without becoming unattractive to investors. The rate on bankers' acceptances is, therefore, to a large extent dependent upon the rate on government paper and in order to preserve their market, the rate on prime bankers' acceptances is often fixed higher than that on government securities. Under such conditions the free movement of the acceptance market is badly restricted.

The influence of commercial paper in the form of the promissory note on the development of acceptances and the discount market is relatively small if compared with that of the call money loans and government securities. Nevertheless, to a certain extent it affects the development of both domestic bankers' and trade acceptances. The difference in the rates of interest between these two types of paper during 1922 was so small that in many instances it was cheaper for a borrower to sell his own single name paper than to ask his bank for an acceptance credit. The margin between the two rates became even narrower during 1923. Thus, for instance, the rate of interest on 90-day prime bankers' bills for the first three months ranged between 4 and $4\frac{1}{2}$ per cent while commercial paper during the period commanded an interest rate of between $4\frac{3}{4}$ and 5 per cent. If even a moderate acceptance commission to the accepting bank be included, one can easily see how near the two rates were. Besides, the more complicated method of handling acceptances and the stricter legal regulations to which they are subject lead business men to prefer commercial paper.

As in the case of the London money market, the New York bill market includes accepting institutions, investors, middlemen and a central banking machinery. However, the nature of these elements is quite different. New York has not developed acceptance

houses, so bills are created by the incorporated banks and trust companies and the private banks as described in Chapter V. The buyers of bills are private persons and financial institutions, including savings banks, which of recent years have been seeking greater liquidity for their assets. While New York has developed several discount companies as indicated above, the brokerage system has not been evolved. The central banking machinery as instituted in the Federal Reserve banks, particularly that of New York, has been the dominant force in developing the bill market. These banks create the ultimate market for bills, and provided these conform with the provisions of Federal Reserve Act and the regulations of the Board, as described in Chapter XIII, the banks have always been ready to absorb any amount of bills offered for sale. In most cases, however, Federal Reserve banks do not appear as active buyers of bills, for their general policy has been rather to stabilize the rate on acceptances and to sustain the market in times of heavy credit demand. At times they do appear in the market either as active buyers or sellers, but merely in order to make effective their discount policy, for in theory it is expected that bankers', as well as trade acceptances, should be carried by member banks or other private holders, except in times of abnormal credit stress.

The open market purchases of Federal Reserve

banks depend to a considerable extent upon the credit conditions of the country and upon the rates which bankers' bills are commanding. As long as banks face a great demand for credit, it is to be expected that a large percentage of bankers' acceptances will be carried by Federal Reserve banks. In times of easy money when large amounts of liquid funds are available in the market, Federal Reserve bank holdings of bankers' acceptances tend to decrease.

Most of the bills bought by Federal Reserve banks are held in the more important banking and money centers of the country, and in fact more than 80 % of all bills held by Federal Reserve banks are divided among the following six Federal Reserve banks, namely, Boston, New York, Cleveland, Chicago, San Francisco, and Philadelphia. The average daily holdings of these six banks as compared with the total holdings of the entire system were 81.3 % for 1919, 90.1 % for 1920, 94.4 % for 1921, and 90.2 % for 1922, of which the New York Federal Reserve bank held 24.1 %, 37.7 %, 35.7 % and 28.7 %, respectively. The holdings of acceptances by the New York Bank fluctuate widely; at times they are small, as for instance, during February, 1921, when they amounted to only 10 per cent, while in other months they are very large, as for instance in September, 1921, amounting to 51 per cent of all bills held by Federal Reserve banks. During 1920, 1921,

and the first half of 1922, more than one third of all bills held by Federal Reserve banks were carried in New York; after October, 1922, the bill holdings of the latter institution decreased relatively. This tendency toward a more even distribution of bills became more pronounced during 1923.

Under the terms of the Federal Reserve Act and the regulations of the Federal Reserve Board, as described in Chapter XIII, acceptances eligible for purchase in the open market or for discount may be divided into four main classes, namely: (1) acceptances arising out of imports or exports, including shipments between foreign countries; (2) acceptances arising out of domestic shipments of goods; (3) acceptances based upon storage of staples, non-perishable goods in warehouses; and (4) dollar exchange. About three-quarters of all acceptances outstanding arise out of the importation or exportation of goods. The open market purchases of acceptances by the Federal Reserve banks are mainly confined to bankers' bills. Of the total bills held at the close of each month for the years 1920, 1921, and 1922, bankers' bills represented 98.4 per cent, 99.7 per cent, and 99.6 per cent, respectively.

Federal Reserve banks buy mainly endorsed bills, which enjoy a preferential rate over unendorsed acceptances. The practice of buying bills direct from acceptors has been almost entirely discon-

tinued, and in cases where such bills are offered for sale to Federal Reserve banks, they are regarded as discount items of the accepting bank.

With regard to acceptors, bills bought by Federal Reserve banks may be divided into three classes, namely: bills accepted by member banks, including national, state banks and trust companies; bills accepted by non-member banks, including discount houses and private bankers; and finally, bills accepted by branches and agencies of foreign banks. By far the largest percentage of bills held by Federal reserve banks are created by member banks.

REDISCOUNTING OF ACCEPTANCES

In addition to their open market purchases, Federal Reserve banks are also authorized to discount both bankers' and trade acceptances. Discounts of bankers' acceptances, however, are made on a much smaller scale than open market purchases and the percentage of discounted bankers' bills to total discounts is quite small. Thus the total volume of all acceptances discounted with Federal reserve banks during 1920, 1921, and 1922 amounted to \$85,330,874,000, \$57,759,128,000, and \$22,082,888,000, as compared with a volume of discounted bankers' bills of \$187,162,000, or .22 per cent; \$57,095,000 or .10 per cent, and \$3,415,000 or .015 per cent, respectively. As the open market rate on prime bankers' acceptances is usually lower

than the authorized discount rate, it is easy to understand why holders of acceptances prefer to sell their bills in the open market than to rediscount them with Federal Reserve banks. Whenever acceptances enjoy a preferential discount rate or whenever their discount rate is lower than the open market rate on prime bills, there is naturally a tendency to offer such bills for discount in a larger quantity. As soon as the open market rate declines below the discount rate, the practice is discontinued and discounts of bankers' bills fall off in consequence.

SUMMARY

In short, the development of bankers' acceptances in the United States has been slow since their growth has been hampered by adverse economic conditions. The main obstacles to the full development of dollar bills and the American discount market are the present call money market system, the large quantity of tax-exempt government securities outstanding, and the disturbed credit and currency conditions in Europe with their depressing effects upon American foreign trade. So long as these conditions continue, it is hardly to be expected that the dollar draft will play the same important rôle in American banking and in the open market as the sterling bill does in the London market. On the other hand, however, measurable

progress has been made. American bankers have become familiar with the principles and laws governing these credit instruments, a fact which enabled the Federal Reserve Board to grant more liberal power to both accepting institutions and Federal Reserve banks. The influence of the latter institutions on the dollar bills and the discount market is still very strong and in times of great credit demand they must carry a large percentage of the total bills outstanding.

CHAPTER XV

FINANCING OF EXPORTS TO COUNTRIES WITH DEPRECIATED CURRENCIES

CREDIT POLICY OF EXPORTERS SELLING TO COUNTRIES WITH DEPRECIATED EXCHANGE

The discussion of export policies and financing methods as described in the previous chapters of this book apply largely to the marketing of products exported to countries with stable exchange. Since, however, a considerable proportion of such exports are shipped to countries with depreciated exchange, attention must be directed to the policies and methods to be followed under such conditions. A wheat or cotton exporter with a thorough knowledge of the market conditions of his product can, with a fair degree of accuracy, judge price variations which constitute the ordinary risks of his business. But when the exporter sells his products in terms of a fluctuating currency, he incurs in addition an exchange risk which is highly speculative in nature. He is able to relieve himself in part of this uncertainty through the system of future exchange as described in Chapter IV.

Loss of exchange to the exporter may also be avoided by not selling in terms of foreign currencies

but in dollars. The result of such a policy is, of course, to throw the risk of exchange fluctuations on the buyer who must either assume this speculative possibility, or through covering shift this risk to some other party who is willing to carry it.

Another effect of a depreciation in the currency of the buying country is to render terms of sale more severe. An exporter in selling his products to a country with a depreciating exchange is inclined to shorten the period of credit extended to the buyer. This is due to the fact that the ability of the latter to meet his obligations at their maturity may be directly impaired by a further decline in the value of his currency. Thus as the exchange rate of marks declined in value, more and more were required by German importers to buy dollars for transmission to foreign exporters. Because of these difficulties not only have our exporters been unwilling to extend credit to Central European buyers, but the latter frequently have not wished to accept credit terms because of the difficulty in meeting such obligations when they finally matured. Hence the sharper the depreciation in currency, the shorter have become credit terms. In selling to Germany cash payment has generally been demanded. As a result the financial burden of shipping products from countries with stable exchange to countries with depreciated currency has been placed upon the latter. The ability of such importers to

carry this financial burden is necessarily limited, so their buying power has been considerably curtailed, and in the case of Central European countries they have been compelled to follow practically a hand-to-mouth policy in their purchases.

FINANCING OF EXPORTS UNDER INTERNATIONAL
BARTER ARRANGEMENTS — OUTRIGHT
BARTER SCHEMES

The collapse of the monetary system in many European countries after 1919 led to a serious movement to transact international business operations without the use of money or credit and instead simply on a purely barter basis. The theory underlying these plans was based on the assumption that since depreciated money was no longer performing effectively its function as a medium of indirect exchange, goods might well be "swapped" directly. Fundamentally, all international commerce is really an exchange of goods or services for other goods or services, and money and credit enter only to express the financial relations or to settle the differences between the debits and the credits among the trading countries. The barter plan was applied quite extensively to specific exchanges of goods between individual exporters and importers of certain countries, but in almost every case there was a certain amount of government supervision or administration.

The following cases of barter may be listed:

- January, 1920: Czecho-Slovakia sent coal and sugar in return for Austria's shipping newsprint paper and manufactured goods. (Amounts not made known.)
- January 20, 1920: Hungary sent food for Austrian clothing, salt, paper.
- February, 1920: Jugo-Slavia sent food for Austrian shipments of salt.
- February, 1920: Austria returned newsprint, agricultural implements, paper goods, glass, clothes, hats, dyes, matches, electric materials, five hundred trucks of salt per month, for cattle, pigs, hides, skins, cement, wood and horns sent by Hungary.
- April, 1920: Czecho-Slovakia sent textiles and paper. Poland returned petroleum and paraffin.
- April, 1920: Austria returned manufactured goods for Italy's advancing 20,000 tons of meal (advance of American relief).
- May, 1920: Austria bartered manufactured goods for raw materials from Hungary to the value of 300,000,000 kronen.
- May, 1920: Denmark and Germany concluded the largest barter arrangement — 20-30 million kronen (Danish) per month. Denmark gave cattle, pigs, horses, and Germany returned coal, iron, steel. (*Economic Review*, November, 1919, to November, 1921.)

In addition, two other exchanges involving Russia may be described. General Denekin, during his campaign in Southern Russia, resorted to a barter arrangement, whereby he was to supply an outward shipment of raw products in exchange for an inward shipment of manufactured goods. The plan failed to operate because of the refusal of the peasantry to deliver sufficient goods, and because of the collapse of the railway system in concentrating, even these

few supplies. Sweden entered into a barter scheme with the Russian Federation of Co-operative Societies. Although the plan had the support of both Swedish and Soviet governments, it proved unsuccessful because of difficulties in assembling and delivering the Russian products.

The most important barter plan arranged since the war was negotiated between Argentine and German interests. The former country as a heavy exporter of frozen meats, grain, wool and hides, was encountering difficulty in marketing these products and so was meeting equal difficulty in paying for necessary manufactured imports. These could be manufactured at low cost in Germany which was in need of the very commodities exportable from Argentina, and so an arrangement was made for the formation in each country of a syndicate supported by local banks and aided by the respective governments. The transactions were to be financed according to the usual banking methods. Thus the Argentine government was to open a confirmed credit with the Banco de la Nacion, the central bank of Argentina, in behalf of the German government as beneficiary. Conversely, the German government was to open a similar credit with one of the big "D" banks, such as the Deutsche or the Dresdner Bank, in favor of the Banco de la Nacion. The latter was also authorized to fix the exchange rates, since the transactions were to be evaluated not in German

marks, but in Argentine gold dollars which were relatively stable. The syndicate in each country was to assemble exports and also to supervise the distribution of imports. The consignments of meat were to be shipped by the Hamburg-American Line, and on arrival, were to be distributed to a chain of retail stores in Germany, Austria, and Czecho-Slovakia. The shipments of supplies from Germany were to be sent to Buenos Aires for forwarding largely to the railways and public works in need of them.

Relatively few barter arrangements have been negotiated by exporters from the United States. Such a plan was evolved by American rice growers who in 1923 planned to induce European exporters to export their goods to the United States where they were to be sold and the proceeds used to buy rice.

MODIFIED BARTER TRANSACTIONS — FINISHING CREDITS

The operations described above were all cases of outright barter involving the exchange of goods for goods. As noted above, although these transactions were peculiar in that they did not involve any settlement either by cash or by credit, they did not differ in nature from the ordinary course of international trade which also involves merely an exchange of goods for goods. However, international commerce

is not necessarily confined to a mutual transfer of goods, but it may also include the matching of the goods of one country against the services of another country. To continue this form of international commerce, a new form of barter transaction known variously as a "finishing," "conversion" or "refining" credit has been devised. Under this plan raw materials or partly manufactured goods are imported by one country which works them into finished form.

This modified form of barter operates in two ways. The importer may obtain the raw materials and manufacture them exclusively for the account of the exporter and for this service he receives a fixed commission. Under these conditions, the manufacturer, sharing neither in the profits nor the losses on the finished products, ceases to be an entrepreneur and acts merely in the combined capacity of a highly specialized foreman, for which service he receives a wage, and of an owner of machinery on which he is paid rent. As a result, this type of transaction has come to be known in Central Europe as "lohnarbeit" (wage work).

Under the other form of conversion-barter the manufacturer retains in part his position as entrepreneur, although only jointly. He receives the raw materials on credit, and after working them into finished goods he redelivers a certain portion to the exporter and withholds the balance to be sold for

his own account. The latter form of finishing credit is greatly preferred by the manufacturer, since he is thereby able to retain his former position as business man and is not reduced to that of laborer even though highly specialized.

PROTECTION OF RIGHTS OF EXPORTERS UNDER BARTER CREDITS

Both of these forms of conversion barter differ from outright barter, in that for a certain period of time the exporter must permit the goods to pass out of his possession without receiving any material value in exchange. This loss of possession for a time proved an obstacle in the operation of such transactions. This impediment was especially serious on the continent where the legal aspects of fiduciary relations have not been well developed. In most countries the law does not recognize a lien on goods while in the hands of debtors, and moreover it generally considers the possession of merchandise by a manufacturer as practically tantamount to ownership. If then, he sells these goods to a third party and goes into bankruptcy, the rights of the third party are usually considered superior to those of the original owner who released them to the manufacturer. True, Continental law holds such an act by the manufacturer as criminal, and imposes severe penalties for this offense, but such punishment brings no material advantage to the

exporter who has parted with his goods under a conversion barter transaction.

Certain precautionary steps may be taken to safeguard the rights of the exporter in accordance with Continental law. These safeguards serve the purpose of giving notice to all parties that the exporter retains continuous title to the goods throughout their process of manufacture. This may be done by having the manufacturer keep separate books and records for all materials so received, by marking or tagging the goods as the property of the exporter and even by labeling the goods in the manufacturing plant. The goods should also be adequately insured at all times against the risks of fire, robbery and damage in transportation or in storage.

These steps cannot well be taken by an exporter living in a foreign country or even by a local agent, since such work requires considerable legal and technical knowledge. To perform these services, special corporations known as "treuhand gesellschaften" have been organized. These institutions are really trustee companies which act as intermediaries between debtors and creditors. The largest of these trust companies, or refinement trusts as they should be termed, is the "Deutsche Industrie Treuhand Aktiengesellschaft," known in abbreviated form as the "Ditag." This organization is supported by thousands of knitting mills and handicraft firms

throughout Central Europe, and is aided by most of the German "D" banks. Private banking interests located particularly in Hamburg established another trustee company called the "Deutsche Waren-Treuhand Aktiengesellschaft." Both these organizations have confined their activities largely to supervising conversion barter transactions and have represented both inland and foreign creditors. These institutions have served solely as trustees and have generally refrained from acting either as bankers or as merchants. They have neither granted loans nor dealt in goods for their own account, and so have adopted the conservative policy of avoiding either credit or mercantile risks. The services of these trust companies in handling cotton and meat products have proven quite satisfactory, according to the statements of American business and banking houses.

In some countries the status of these companies and the rights of creditors under conversion barter transactions have received added protection by revisions in the local law. This is particularly true in Austria where special legislation was enacted providing for the registration of such barter transactions with the Chamber of Commerce. Such entry gives greater protection to the property rights of the foreign owner of the goods, even in the event of the bankruptcy of the debtor (executive order of July 16, 1920, of the Office of Justice). The more important sections of this law read as follows:

(1) "The consignee has to designate as far as possible by distinguishing marks the raw materials received and the products manufactured out of them and to keep them separate from similar raw materials and products. He has to keep exact accounts as to the quantities of the consigned raw materials and of the products manufactured out of them and to show at any given moment the names and addresses of the people to whom the raw materials and products have been entrusted. The consignor or his agent must be allowed at any time to examine these accounts.

(2) The consignee or anybody, who has received, directly or indirectly, such raw materials or products manufactured out of them, for the purpose of manufacturing, is bound to grant permission to the consignor or his agents to inspect his premises and the goods stored therein, in so far as it is necessary for controlling how the consignee has been dealing with them.

(3) The consignee and the persons mentioned in subsection 2 may refuse the right of inspection to the agent of the consignor, if such agent or his employer are competitors of the consignee.

(4) If, in the case of bankruptcy of the consignee the right is claimed of excluding goods from the bankrupt estate and a dispute arises, whether the raw materials or products in the bankrupt estate come from the consignor or have been manufactured out of raw materials furnished by him, the consignor may, without having to give proof of any danger arising from him, demand by injunction, the temporary seclusion — until further notice — of the whole stock of such raw materials or products manufactured out of such raw materials, from the bankrupt estate. The Court may, however, on an application made or ex officio, limit the exclusion to a part of the stock, if it is evident that the temporary exclusion is not required to such an extent, in order to cover the claim or if raw materials or products, clearly belonging to third persons, are involved."

The Austrian government has endeavored to remove obstacles to the movement of goods under

conversion credits by waiving import duties on raw materials and export charges on the finished goods.

THE UNITED STATES-CZECHO-SLOVAK COTTON FINISHING CREDIT

The conversion barter plan was applied in 1920 to the shipment of cotton from the United States to Czecho-Slovakia. Through arrangements entered into by certain business and banking interests both in the United States and in Central Europe, cotton was shipped from inland centers of the United States to the seaboard where it was inspected by an agent acting for the foreign manufacturer. If the cotton was accepted, it was mingled with other shipments of like quality which were then divided into lots of one thousand or more bales. The original owner was given a trust receipt and also a participation certificate to protect his rights in the cotton. The entire transaction was guaranteed further by the foreign spinners, by their banks, and in the case of Czecho-Slovakia by the government itself. In time the cotton was shipped to Hamburg, whence it was mainly reforwarded to Czecho-Slovakia. Here the mills converted the cotton into cloth or yarn and redelivered these finished goods to warehouses in Hamburg and in other Continental ports where they were in time sold. After paying the bankers, the mill owners and the middlemen for their services in financing, manufacturing and marketing the

cotton, the proceeds were then distributed *pro rata* among the American exporters. In this way, over 20,000 bales of rather low grade cotton were marketed abroad at prices which were more favorable than would have been obtained in the domestic market. (*Federal Reserve Bulletin*, May, 1923, p. 575.) The benefits of the plan were to a certain extent lessened for both parties by sharp fluctuations in the price of cotton.

American cotton exporters also made shipments to German mills particularly in Saxony on a barter basis whereby the manufacturers did not receive cash payment but were allowed to retain a portion of the finished goods.

NETHERLANDS-GERMAN CREDIT

The largest conversion credit was the one extended by Dutch financial interests to Germany in 1920. The seaports of Holland have always handled a large proportion of the German overseas trade, but this transit business was seriously affected by the inability of German manufacturers to obtain credit for financing their enterprises. Hence, arrangements were concluded to make available a credit of 200,000,000 guilders, which at normal exchange is worth about \$80,000,000. Of this sum, 60,000,000 guilders were to constitute a single non-renewable credit for the purchase of food supplies, while for the buying of raw materials the remaining 140,000,000

guilders were to stand as a revolving credit which could be continually renewed as soon as any part was utilized and paid. The foodstuffs were to come largely from Holland but the raw materials might be obtained anywhere, with the understanding that Dutch sellers should be given preference, and in any event the goods were to be handled only through Holland ports.

It is thus seen that the above plan differs from the other forms of barter credits in that the manufacturer does not obtain the raw materials directly from the grantor but receives rather a credit in a foreign currency of stable value with which he is enabled to make his purchases in any market. The proceeds derived from the sale of the finished goods are applied directly to the payment of the advances made by the creditor. As in the case of other refining credits, the transactions were administered by a trustee company, in this case the "Treuhand Gesellschaft fuer das Niederlaendische Kredit Ackommen" (Trust Company for the Netherlands Credit Agreement), which was organized especially for supervising this particular credit. German manufacturers, desiring credit from this source, were required to submit to the trust company an application describing the nature of the proposed transaction and giving a statement of their financial condition.

During the first year of its operation the credit

was little used and it was generally regarded as a complete failure. However, the collapse of the mark and the consequent scarcity of credit in Germany rendered it difficult for manufacturers to finance their enterprises either from their own resources or those of their banks. Hence, recourse was had to the Dutch credit which proved the largest credit reservoir open to the Germans, and thus furnished them with facilities for importing raw materials and also foodstuffs. The advantage is rather on the side of the borrower than of the lender. German manufacturers have been able to obtain credit at comparatively low rates of interest. In fact, the credit facilities offered to German manufacturers by the Dutch banks proved so cheap that American financial interests contemplating similar offers could not well meet the competition.

FINANCING OF EXPORTS BY GOVERNMENTAL CREDIT

The period immediately after the cessation of hostilities in 1918 was marked by a sharp increase in the international flow of goods especially to markets which had been closed during the preceding four years. This movement reached its height toward the end of 1919, but the following year witnessed a general collapse in international trade. Its causes were multifarious in nature, but it was popularly ascribed to an inadequate supply of credit

available for the movement of goods between countries. This lack of credit, it was claimed, proved particularly burdensome for exporters dealing with importers in countries having depreciated currencies, since the low rate of exchange made it difficult for the latter to carry the credit burden for financing their purchases.

The continued fall in the value of the currencies of countries with low exchanges and the prolongation of the crisis in the export trade, led to widespread unemployment in exporting countries with high exchanges. As a result there was an insistent popular demand upon the government to use public money as a basis of credit for facilitating exports.

SWEDISH PLAN

The first country to consider a plan of government export credits was Sweden which experimented with a government export credit plan even before the close of the war. In September, 1917, the Government appointed a financial council to co-operate with institutions engaged in extending foreign credit. No material aid was given by the government until the passage, some time later, of a relief credit scheme. This plan was aimed to facilitate the export of Swedish industrial products to the new Baltic states and to Central Europe. Because of the uncertain economic conditions in these countries trading with them places upon the Swedish manu-

facturer and exporter an abnormal credit risk, part of which the Swedish Government offered to assume.

BRITISH LEGISLATION ON EXPORT CREDITS

The problem of furnishing international credit in the reconstruction period was studied by the British Government while the war was still in progress. A committee on financial facilities was appointed in 1917, and in the following year it submitted a report which, among other matters, expressed the opinion that the existing banking institutions would be well able to provide sufficient credit to meet the needs of post-war financing. In view of this conviction, the committee made no recommendation for government export credit.

The movement for government aid in the financing of exports from the United Kingdom may be traced to the action of the British Board of Trade in 1919, in extending the operation of its "War Risk Insurance Office." At the request of British exporters, this department was given power to grant insurance against inland risks on British goods imported into certain districts of southern Russia. This act in itself did not provide government credit for these export transactions, but it was hoped that shipments so protected would be more readily financed by banks and acceptance houses. This thought was expressed in the official announcement of the

British government in the *Board of Trade Journal* of June 26, 1919, which read in part as follows:

"What is now proposed is that through the operations of the War Risks Office there should be provided facilities for the insurance at reasonable rates of goods in process of exchange between Great Britain and these countries. Given the security which insurance will provide, it is believed that banks will be ready to co-operate in the re-establishment of trade by giving advances in the ordinary way of business traders in respect of insured goods exported from and imported into the United Kingdom."

A few months later a sum not exceeding £26,000,000 was granted to the Board of Trade for the purpose of allowing exporters advances up to 80 per cent of their shipment to certain Balkan, Baltic, and Central European countries. In explaining the purpose of the plan to the House of Commons, the Prime Minister said:

"We hope as a result of the institution of these credits to those countries that a beginning will be made to restore trade, because those countries have a good deal to sell, and all you want to do is to have a beginning of business, and once it begins the natural course of exchange will enable you to go on; and I venture to predict that on the credits we establish we shall not lose a material amount, while the benefit to the trade of the country will be enormous. I hope the banking houses will be encouraged to play a large part in what is wanted to be done."

Neither of these plans was employed to any considerable extent by British exporters. The special division of the Board of Trade organized for insuring Russian commerce performed practically no busi-

ness save that of quoting rates, since the actual covering of these risks was undertaken almost entirely by private firms.

Likewise the facilities offered by the Export Credit Department of the Board of Trade remained little used. In 1920, Parliament passed the Overseas Trade (credits and insurance) Act which provided, as the name indicates, both for the granting of credits and the undertaking of insurance by the Board of Trade on behalf of British exporters of manufactured goods. Where advances had so far been limited to 80 per cent of the value of the shipment, the government was now empowered to advance up to 100 per cent on the full value, provided that the exporters carried 20 per cent of the risk on the goods, and that the importer offered adequate security. However, few credits were granted under this Act, and so its provisions were further liberalized by the Overseas Trade (credits and insurance) Amendment Act of 1921. The amendment also changed the purpose of the scheme from primarily a system of credit facility granting to one of credit insurance underwriting. The government agreed to guarantee the payment of drafts covering all kinds of goods, except munitions manufactured in and exported from the United Kingdom. In order to avail himself of these guarantees, an exporter was required to submit an application form presented through his banker and bearing the latter's recommendation.

These guarantees could be both general or specific in nature. The former did not require the exporter to refer each transaction to the Board of Trade, since he was permitted to apply for a general guarantee up to a certain amount to cover his dealings with specific countries over a period of time not to exceed twelve months in all. If the exporter's application was accepted by the credit department, he then drew his drafts on the importer or on the latter's bank, and payment was guaranteed by the government. Under the general guarantee plan the Department did not require any foreign security from the importer, but it retained the right of recourse up to $57\frac{1}{2}$ per cent of the loss against the exporter as drawer of the bill.

A typical general guaranty operated as follows:

"An exporter applies to the Export Credits Department through his bank for a general credit of £10,000 in respect of business to be done with importers in Roumania.

Department, after obtaining such information as may be required regarding exporter's financial standing, agrees for the next six months to guarantee bills up to this amount, and fixes a commission. These bills must have as short a duration as possible, but renewals will be permitted if necessary, provided that the credit shall in no case exceed twelve months in all. Each bill is guaranteed by the Government for the full amount of the bill, and can then be discounted in the ordinary manner by the exporter. At the end of the six months, the total of the bills guaranteed amounts to, say, £9,500 (assuming that the exporter has not been able to do the full amount of business anticipated). When the bills fall due, the Government has to make good any default which may occur but has recourse to the

exporter for $57\frac{1}{2}$ per cent of the ultimate loss." (From circular issued by Export Credits Department.)

As a result of the government's guaranty, the draft drawn under the above arrangement had greater security than even a prime banker's bill, since it possessed practically the same force as a treasury bill. The government offered to guarantee bills up to 100 per cent of their value for a specific transaction but only on condition that the credit so extended should not exceed twelve months in duration. Beyond this period of time the government would guarantee no more than 85 per cent of the amount of the bill. The government export department was empowered not alone directly to guarantee exporters against loss but also indirectly through participation with banking institutions engaged in financing foreign trade. The extent of the government's participation was limited to 70 per cent of any loss incurred by the banks.

An appraisal of the entire government export credit program was stated by the Chancellor of the Exchequer, Sir Robert Horne, in an address which read in part as follows (Commerce Reports, Sept. 14, 1921, p. 657):

"Dealing with the export-credit scheme, it has not been a success. It is said that the committee which dealt with these matters applied too rigid business principles to the transactions. That simply means that they declined to take big risks. To improve the export-credit scheme to the extent of offering goods practically for nothing would not increase trade for the

derelict countries of Europe. The real truth is that the countries want raw material, and have no money to pay for manufactured articles."

The act of 1921, usually referred to as the Trade Facilities Act, as amended in 1922, provided guarantees not only for the facilitation of short-term or commercial credit but also for the encouragement of long-term or capital loans. These are to be granted by private corporations but the British Treasury, acting on the recommendation of an advisory committee, guarantees the payment of both the interest and principal of such extensions, provided the proceeds are expended on goods manufactured within the United Kingdom, and not simply to fund already existing obligations. As in the case of the other schemes, the object of this plan is also to facilitate the export of goods from Great Britain. Up to October 23, 1923, the Government had guaranteed the sum of £37,000,000 in loans, applied to such purposes as the erecting of pulp mills in Newfoundland, or a railway in the Sudan or a hydroelectric plant in India.

BELGIAN EXPORT CREDIT PLAN

The motive underlying the British plans outlined above was aimed only indirectly to facilitate exports but more directly to reduce unemployment. In a way the acts were part of the program to relieve the widespread distress among the workers, and the

supporters of the plan hoped that it would prove a substitute for the system of unemployment doles which was proving costly and was generally regarded as economically unsound.

The same purpose prompted Belgium in enacting on August 7, 1921, a system of government guarantees for export credits. Belgium is primarily a manufacturing country and the depression in foreign markets following 1920 caused distress in many lines of industry.

Under the Belgian government plan, guarantees were to be granted to aid the financing of two large undertakings, one covering the export of rolling stock to Argentina, the other the shipment of cotton yarn to Roumania. The former guaranty was granted to the Ateliers de Construction de Familleureux which had received a large order from the Argentine State railway for rolling stock amounting to 14,793,560 Belgian francs. Fifty-five per cent of this sum was guaranteed by the government, while the remainder was carried by the construction company itself and a banking institution.

The other government guaranty was extended to "La Textile," a large co-operative spinning society of Ghent, which had contracted to export 400,000 kilograms of yarn to a Roumanian cloth mill.

While the Belgian export credit plan is similar to the British scheme in that it is designed to facilitate the movement of manufacturing goods and so to

relieve industrial unemployment, the two plans have operated quite differently. The British plan has been used mainly by small exporters whose limited credit standing rendered it difficult for them to obtain sufficient credit from their banks. The beneficiaries under the Belgian plan have been large exporters with considerable credit resources. Besides the two credits described above, the Belgian Government guaranty has been practically unused. One reason advanced for its non-use is the cumbersome nature of the official machinery and the consequent unwillingness of exporters to adjust their business arrangements to the complicated rules of government administration. In discussing the reasons for the failure of Belgian business men to use the plan, the writer was told that there was really no need for government credit since the banks stood ready to advance sufficient funds to finance sound foreign trade.

HOLLAND PLAN

One important economic effect of the war upon Holland was to increase the productive capacity of its manufacturing plants, and thus accentuate the need of foreign markets. The appreciation in guilder exchange and the correlative depreciation in the value of Central European currencies seriously interrupted the export of Dutch goods to these nations. While the year 1922 witnessed a business

recovery in some countries, economic conditions in Holland continued unsatisfactory. There was an insistent demand for a protective tariff, and partly as a substitute the government in September, 1922, enacted an export credit plan modeled largely after the British experiment. The Dutch guarantee plan failed to work satisfactorily and a few months later it underwent drastic amendment. According to the old arrangement the government extended its guarantee to the exporter's bank, but under the present plan the guarantee is given to the exporter himself. Through his bank he submits an application to a committee charged with the administration of the government plan. This body may call upon the bank for a complete statement of the financial condition of the exporter, an explanation of the reasons why credit cannot be obtained from private sources and particularly the nature of the export transaction which must serve as the underlying security. If these factors prove satisfactory to the committee, it will then recommend that the government grant a guarantee to a maximum of forty per cent of the business transaction of the exporter on his paying a small premium.

FRENCH NATIONAL BANK FOR FOREIGN TRADE

Since the close of the war, France has turned actively to the development of her overseas trade. This country has not imitated other nations in

setting up a government export credit scheme but instead has established a special banking organization known as the "Banque Nationale du Commerce Exterieur" (National Bank for Foreign Trade). This institution has the unofficial support of the Bank of France and its stock is mainly held by the big credit banks. The purpose of this special trade bank was to afford long-term credits and general foreign service to French merchants especially in dealing with countries of depreciated currencies. To date the bank has not, however, functioned on a wide scale, since the regular institutions for extending overseas credit have met the legitimate needs of French exporters.

WAR FINANCE CORPORATION

The plans for government credits to finance exports, as described above, applied largely to the movement of manufactured goods. In the case of the United States, interest centered mainly in facilitating the exportation of agricultural products, which were seriously affected by the world-wide crisis of 1920. One of the measures taken by the government to relieve this situation was the revival of the War Finance Corporation by Congress in January, 1921. This institution had been created in 1918 to aid the program of war financing and so its activities had been suspended by the Secretary of the Treasury in May, 1920. Since its reconstruc-

tion in 1921, the War Finance Corporation has received wider powers under the Agricultural Credit Act of August 24, 1921, and has been authorized not alone to engage in export finance, but also to extend credit for domestic marketing of agricultural products. Specifically the War Finance Corporation is directed to provide credit facilities not alone to exporters and their banks, but also to dealers in agricultural commodities, for their carrying in anticipation of their ultimate exportation. The Corporation was also empowered to grant advances to foreign buyers of American agricultural products. Advances are granted only under conditions as stated in circulars issued by the Corporation. The borrower must show that he holds a definite contract of sale for his shipment and that he is unable to obtain the necessary accommodation at reasonable rates from regular banking sources. Also the advances must be fully protected by acceptable collateral.

The active operation of the Corporation has been impeded by the continued uncertainty of the foreign exchanges. European buyers have been unwilling to avail themselves of the possibility of securing direct credit extensions from the Corporation because of the difficulty in ultimately meeting their obligations if their currencies depreciated further. As shown in previous sections of this series, the collapse of the international banking machinery in

many of the European countries made it difficult for foreign buyers to adopt a policy, as was their custom before the war, of laying in a big supply of foodstuffs and raw materials well in advance of their needs. Now these buyers are forced to follow a hand-to-mouth policy and are able to carry stock only for their immediate needs. Hence the financial burden of carrying these products devolves largely upon the seller. To meet these needs the War Finance Corporation may grant advances on products to be held temporarily in warehouses in the United States but to be exported before the maturity of the advance.

Of particular interest have been the advances extended by the War Finance Corporation to co-operative associations. According to section 24 of the amendments under the Agricultural Credits Act, the Corporation was empowered to grant financial aid to any co-operative association of producers. As the meaning of the term "co-operative association" is not clearly defined, the Corporation in its rulings has established certain general requirements as to legal nature, purpose, and operation, which must be met before any assistance will be given.

The association must be incorporated whether as a stock or non-stock organization. It must be formed for a truly co-operative purpose as indicated by the fact that the proceeds are distributed to members in proportion to the extent of the interest

in the products handled by the association, and it must have full freedom of operation in its right to sell or pledge the commodities which are being marketed. Besides these general regulations, the Corporation in dealing with the co-operatives has framed its individual agreements, so that credit will be extended to aid the orderly marketing of products and not to facilitate their holding merely for speculative gain.

As mentioned above, the War Finance Corporation was originally organized as a war measure and was revived to meet the needs of the special agricultural export crisis. It is, however, a temporary organization whose life has been extended from year to year as for example under the act approved June 10, 1922, it was continued until June 30, 1923, and by the Act of March 4, 1923, it was further renewed until March 31, 1924.

APPENDIX NO. I

GEOGRAPHIC DISTRIBUTION OF FOREIGN BRANCHES AND AGENCIES OF BRITISH AND AMERICAN BANKS

(British) *Bankers Almanac and Year Book*, 1922-23

(American) *Federal Reserve Bulletin*, November, 1922, p. 1299

	BRITISH BRANCHES	AMERICAN BRANCHES
I. North America		
Canada.....	4	..
Central America		
Guatemala.....	1	..
Nicaragua.....	1	4
Panama Canal Zone.....	..	2
Republic of Panama.....	..	3
Salvador.....	1	..
Mexico.....	1	2
United States.....	13	..
West Indies.....	27	33
II. South America		
Argentine Republic.....	24	3
Brazil.....	33	5
British Guiana.....	6	..
Chile.....	13	2
Colombia.....	7	7
Ecuador.....	1	1
Paraguay.....	1	..
Peru.....	2	7
Uruguay.....	11	2
Venezuela.....	2	5
III. Europe		
Austria.....	25	..
Belgium.....	6	4
Denmark.....	1	..
England.....	..	8

	BRITISH BRANCHES	AMERICAN BRANCHES
III. Europe — <i>Continued</i>		
France.....	28	7
Germany.....	4	2
Gibraltar.....	1	..
Greece.....	14	..
Hungary.....	1	..
Italy.....	6	1
Jugo Slavia.....	1	..
Malta.....	2	..
Netherlands.....	2	..
Norway.....	2	..
Portugal.....	2	..
Roumania.....	4	..
Russia.....	..	2 ¹
Serbia.....	1	..
Spain.....	10	2
Switzerland.....	3	..
Turkey.....	2	..
IV. Asia		
Arabia.....	3	..
China.....	13	16
East Indies Region		
Dutch East Indies.....	2	..
Federated Malay States.....	6	..
Java.....	..	2
Malaysia.....	1	..
Philippines.....	4	3
Straits Settlements.....	6	2
French Indo-China.....	2	..
India.....	71	2
Japan.....	2	5
Persia.....	19	..
Siam.....	2	..
Turkey (Palestine).....	32	..
V. Australia		
New South Wales.....	196	..
New Zealand.....	175	..

¹ (Temporarily closed)

	BRITISH BRANCHES	AMERICAN BRANCHES
Queensland	76	...
South Australia.....	57	...
Tasmania.....	40	...
Victoria.....	225	...
Western Australia.....	38	...
VI. Africa		
Algeria.....	3	...
Anglo-Egyptian Sudan.....	3	...
East Africa.....	11	...
Egypt.....	26	...
Liberia.....	1	...
Morocco.....	9	...
Southern Part		
Cape Province.....	184	...
Kruya Col.....	7	...
Natal.....	26	...
Nyasaland.....	4	...
Orange Free State.....	32	...
Rhodesia.....	20	...
South Africa.....	6	...
Southwest Africa.....	9	...
Tanganyika.....	8	...
Transvaal.....	64	...
All Others.....	5	...
West Africa.....	61	...

TOTALS

	BRITISH BRANCHES	AMERICAN BRANCHES
I. North America.....	48	44
II. South America.....	100	32
III. Europe.....	115	24
IV. Asia.....	163	30
V. Australia.....	807	...
VI. Africa.....	479	...
Grand Totals.....	1712	130

APPENDIX NO. II

REGULATION OF THE FEDERAL RESERVE BOARD ON CORPORATIONS ORGANIZING UNDER THE EDGE ACT

(Regulation K series of 1923)

BANKING CORPORATIONS AUTHORIZED TO DO FOR- EIGN BANKING BUSINESS UNDER THE TERMS OF SECTION 25 (a) OF THE FEDERAL RESERVE ACT

I. ORGANIZATION

Any number of natural persons, not less in any case than five, may form a Corporation¹ under the provisions of section 25 (a) for the purpose of engaging in international or foreign banking or other international or foreign financial operations or in banking or other financial operations in a dependency or insular possession of the United States either directly or through the agency, ownership, or control of local institutions in foreign countries or in such dependencies or insular possessions.

II. ARTICLES OF ASSOCIATION

Any persons desiring to organize a corporation for any of the purposes defined in section 25 (a) shall enter into articles of association (see F. R. B. Form 151 which is suggested as a satisfactory form of articles of association) which shall specify in general terms the objects for which the Corporation is formed, and may contain any other provisions not inconsistent with law which the Corporation may see fit to adopt for the regu-

¹ Whenever these regulations refer to a Corporation spelled with a capital C, they relate to a corporation organized under section 25 (a) of the Federal Reserve Act.

lation of its business and the conduct of its affairs. The articles of association shall be signed by each person intending to participate in the organization of the Corporation and when signed shall be forwarded to the Federal Reserve Board in whose office they shall be filed.

III. ORGANIZATION CERTIFICATE

All of the persons signing the article of association shall under their hands make an organization certificate on F. R. B. Form 152, which is made a part of this regulation, and which shall state specifically:

First. The name assumed by the Corporation.

Second. The place or places where its operations are to be carried on.

Third. The place in the United States where its home office is to be located.

Fourth. The amount of its capital stock and the number of shares into which it shall be divided.

Fifth. The names and places of business or residences of persons executing the organization certificate and the number of shares to which each has subscribed.

Sixth. The fact that the certificate is made to enable the persons subscribing the same and all other persons, firms, companies, and corporations who or which may thereafter subscribe to or purchase shares of the capital stock of such Corporation to avail themselves of the advantages of this section.

The persons signing the organization certificate shall acknowledge the execution thereof before a judge of some court of record or notary public who shall certify thereto under the seal of such court or notary. Thereafter the certificate shall be forwarded to the Federal Reserve Board to be filed in its office.

IV. TITLE

Inasmuch as the name of the Corporation is subject to the approval of the Federal Reserve Board, a preliminary applica-

tion for that approval should be filed with the Federal Reserve Board on F. R. B. Form 150, which is made a part of this regulation. This application should state merely that the organization of a Corporation under the proposed name is contemplated and may request the approval of that name and its reservation for a period of 30 days. No Corporation which issues its own bonds, debentures, or other such obligations will be permitted to have the word "bank" as a part of its title. No Corporation which has the word "Federal" in its title will be permitted also to have the word "bank" as part of its title. So far as possible the title of the Corporation should indicate the nature or reason of the business contemplated and should in no case resemble the name of any other corporation to the extent that it might result in misleading or deceiving the public as to its identity, purpose, connections, or affiliations.

V. AUTHORITY TO COMMENCE BUSINESS

After the articles of association and organization certificate have been made and filed with the Federal Reserve Board, and after they have been approved by the Federal Reserve Board and a preliminary permit to begin business has been issued by the Federal Reserve Board, the association shall become and be a body corporate, but none of its powers except such as are incidental and preliminary to its organization shall be exercised until it has been formally authorized by the Federal Reserve Board by a final permit generally to commence business.

Before the Federal Reserve Board will issue its final permit to commence business, the president or cashier, together with at least three of the directors, must certify (a) that each director elected is a citizen of the United States; (b) that a majority of the shares of stock is owned by citizens of the United States, by corporations the controlling interest in which is owned by citizens of the United States, chartered under the laws of the United States, or by firms or companies the controlling interest in which is owned by citizens of the United States; and (c) that

of the authorized capital stock specified in the articles of association at least 25 per cent has been paid in in cash and that each stockholder has individually paid in in cash at least 25 per cent of his stock subscription. Thereafter the cashier shall certify to the payment of the remaining installments as and when each is paid in, in accordance with law.

VI. CAPITAL STOCK

No Corporation may be organized under the terms of section 25 (a) with a capital stock of less than \$2,000,000. The par value of each share of stock shall be specified in the articles of association, and no Corporation will be permitted to issue stock of no par value. If there is more than one class of stock, the name and amount of each class and the obligations, rights, and privileges attaching thereto shall be set forth fully in the articles of association. Each class of stock shall be so named as to indicate to the investor as nearly as possible what is its character and to put him on notice of any unusual attributes.

VII. TRANSFERS OF STOCK

Section 25 (a) provides in part that —

A majority of the shares of the capital stock of any such corporation shall at all times be held and owned by the citizens of the United States, by corporations the controlling interest in which is owned by citizens of the United States, chartered under the laws of the United States or of a State of the United States, or by firms or companies the controlling interest in which is owned by citizens of the United States.

In order to insure compliance at all times with the requirements of this provision after the organization of the Corporation, shares of stock shall be issuable and transferable only on the books of the Corporation. Every application for the issue or transfer of stock shall be accompanied by an affidavit of the party to whom it is desired to issue or transfer stock, or by his or its duly authorized agent, stating —

In the case of an individual. — (a) Whether he is or is not a citizen of the United States and if a citizen of the United States, whether he is a natural born citizen or a citizen by naturalization, and if naturalized, whether he remains for any purpose in the allegiance of any foreign sovereign or state; (b) Whether there is or is not any arrangement under which he is to hold the shares or any of the shares which he desires to have issued or transferred to him, in trust for or in any way under the control of any foreign state or any foreigner, foreign corporation, or any corporation under foreign control, and if so, the nature thereof.

In the case of a corporation. — (a) Whether such corporation is or is not chartered under the laws of the United States or of a State of the United States. If it is not, no further declaration is necessary, but if it is, it must also be stated (b) whether the controlling interest in such corporation is or is not owned by citizens of the United States, and (c) whether there is or is not any arrangement under which such corporation will hold the shares or any of the shares if issued or transferred to such corporation, in trust for or in any way under the control of any foreign state or any foreigner or foreign corporation or any corporation under foreign control, and if so, the nature thereof.

In the case of a firm or company. — (a) Whether the controlling interest in such firm or company is or is not owned by citizens of the United States and, if so, (b) whether there is or is not any arrangement under which such firm or company will hold the shares or any of the shares if issued or transferred to such firm or company in trust for or in any way under the control of any foreign state or any foreigner or foreign corporation or any corporation under foreign control and if so, the nature thereof.

The board of directors of the Corporation, whether acting directly or through an agent, may, before making any issue or transfer of stock, require such further evidence as in their discretion they may think necessary in order to determine whether or not the issue or transfer of the stock would result in a violation of the law. No issue or transfer of stock which would cause 50 per cent or more of the total amount of stock issued

or outstanding to be held contrary to the provisions of the law or these regulations shall be made upon the books of the Corporation. The decision of the board of directors in each case shall be final and conclusive and not subject to any question by any person, firm, or corporation on any ground whatsoever.

If at any time by reason of the fact that the holder of any shares of the Corporation ceases to be a citizen of the United States, or, in the opinion of the board of directors, becomes subject to the control of any foreign state or foreigner or foreign corporation or corporation under foreign control, 50 per cent or more of the total amount of capital stock issued or outstanding is held contrary to the provisions of the law or these regulations, the board of directors may, when apprised of that fact, forthwith serve on the holder of the shares in question a notice in writing requiring such holder within two months to transfer such shares to a citizen of the United States, or to a firm, company, or corporation approved by the board of directors as an eligible stockholder. When such notice has been given by the board of directors the shares of stock so held shall cease to confer any vote until they have been transferred as required above and if on the expiration of two months after such notice the shares shall not have been so transferred, the shares shall be forfeited to the Corporation.

The board of directors shall prescribe in the by-laws of the Corporation appropriate regulations for the registration of the shares of stock in accordance with the terms of the law and these regulations. The by-laws must also provide that the certificates of stock issued by the Corporation shall contain provisions sufficient to put the holder on notice of the terms of the law and the regulations of the Federal Reserve Board defining the limitations upon the rights of transfer.

VIII. OPERATIONS IN THE UNITED STATES

No Corporation shall carry on any part of its business in the United States except such as shall be incidental to its international or foreign business. Agencies may be established

in the United States with the approval of the Federal Reserve Board for specific purposes, but not generally to carry on the business of the Corporation.

IX. INVESTMENTS IN THE STOCK OF OTHER CORPORATIONS

It is contemplated by the law that a Corporation shall conduct its business abroad either directly or indirectly through the ownership or control of corporations, and it is accordingly provided that a Corporation may invest in the stock, or other certificates of ownership, of any other corporation organized —

- (a) Under the provisions of section 25 (a) of the Federal Reserve Act;
- (b) Under the laws of any foreign country or a colony or dependency thereof;
- (c) Under the laws of any State, dependency, or insular possession of the United States;

provided, first, that such other corporation is not engaged in the general business of buying or selling goods, wares, merchandise, or commodities in the United States; and second, that it is not transacting any business in the United States except such as is incidental to its international or foreign business.

Except with the approval of the Federal Reserve Board, no Corporation shall invest an amount in excess of 15 per cent of its capital and surplus in the stock of any corporation engaged in the business of banking, or an amount in excess of 10 per cent of its capital and surplus in the stock of any other kind of corporation.

No Corporation shall purchase any stock in any other corporation organized under the terms of section 25 (a) or under the laws of any State, which is in substantial competition therewith, or which holds stock or certificates of ownership in corporations which are in substantial competition with the purchasing Corporation. This restriction, however, does not apply to corporations organized under foreign laws.

X. BRANCHES

No Corporation shall establish any branches except with the approval of the Federal Reserve Board, and in no case shall any branch be established in the United States.

XI. ISSUE OF DEBENTURES, BONDS, AND PROMISSORY NOTES

Approval of the Federal Reserve Board. — No Corporation shall make any public or private issue of its debentures, bonds, notes, or other such obligations without the approval of the Federal Reserve Board, but this restriction shall not apply to notes issued by the Corporation in borrowing from banks or bankers for temporary purposes not to exceed one year. The approval of the Federal Reserve Board will be based solely upon the right of the Corporation to make the issue under the terms of this regulation and shall not be understood in any way to imply that the Federal Reserve Board has approved or passed upon the merits of such obligations as an investment. The Federal Reserve Board will consider the general character and scope of the business of the Corporation in determining the amount of debentures, bonds, notes, or other such obligations of the Corporation which may be issued by it.

Application. — Every application for the approval of any such issue by a Corporation shall be accompanied by (1) a statement of the condition of the Corporation in such form and as of such date as the Federal Reserve Board may require; (2) a detailed list of the securities by which it is proposed to secure such issue, stating their maturities, indorsements, guaranties, or collateral, if any, and in general terms the nature of the transaction or transactions upon which they were based; and (3) such other data as the Federal Reserve Board may from time to time require.

Advertisements. — No circular, letter, or other document advertising the issue of the obligations of a Corporation shall state or contain any reference to the fact that the Federal Reserve Board has granted its approval of the issue to which

the advertisement relates. This requirement will be enforced strictly in order that there may be no possibility of the public's misconstruing such a reference to be an approval by the Federal Reserve Board of the merits or desirability of the obligations as an investment.

XII. SALE OF FOREIGN SECURITIES

Approval of the Federal Reserve Board. — No Corporation shall offer for sale any foreign securities with its indorsement or guaranty, except with the approval of the Federal Reserve Board, but such approval will be based solely upon the right of the Corporation to make such a sale under the terms of this regulation and shall not be understood in any way to imply that the Federal Reserve Board has approved or passed upon the merits of such securities as an investment.

Application. — Every application for the approval of such sale shall be accompanied by a statement of the character and amount of the securities proposed to be sold, their indorsements, guaranties, or collateral, if any, and such other data as the Federal Reserve Board may from time to time require.

Advertisements. — No circular, letter, or other document advertising the sale of foreign securities by a Corporation with its indorsement or guaranty shall state or contain any reference to the fact that the Federal Reserve Board has granted its approval of the sale of the securities to which the advertisement relates.

XIII. ACCEPTANCES

Kinds. — Any Corporation may accept (1) drafts and bills of exchange drawn upon it which grow out of transactions involving the importation or exportation of goods, and (2) drafts and bills of exchange which are drawn by banks or bankers located in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange as required by the usages of trade in such countries, dependencies, and possessions, provided, however, that, except

with the approval of the Federal Reserve Board and subject to such limitations as it may prescribe, no Corporation shall exercise its power to accept drafts or bills of exchange if at the time such drafts or bills are presented for acceptance it has outstanding any debentures, bonds, notes, or other such obligations issued by it.

Maturity. — Except with the approval of the Federal Reserve Board, no Corporation shall accept any draft or bill of exchange which grows out of a transaction involving the importation or exportation of goods with a maturity in excess of six months, or shall accept any draft or bill of exchange drawn for the purpose of furnishing dollar exchange with a maturity in excess of three months.

Limitations. — (1) Individual drawers: No acceptances shall be made for the account of any one drawer in an amount aggregating at any time in excess of 10 per cent of the subscribed capital and surplus of the Corporation, unless the transaction be fully secured or represents an exportation or importation of commodities and is guaranteed by a bank or banker of undoubted solvency. (2) Aggregates: Whenever the aggregate of acceptances outstanding at any time (a) exceeds the amount of the subscribed capital and surplus, 50 per cent of all the acceptances in excess of the amount shall be fully secured; or (b) exceeds twice the amount of the subscribed capital and surplus, all the acceptances outstanding in excess of such amount shall be fully secured. (The Corporation shall elect whichever requirement (a) or (b) calls for the smaller amount of secured acceptances.) In no event shall any Corporation have outstanding at any one time acceptances drawn for the purpose of furnishing dollar exchange in an amount aggregating more than 50 per cent of its subscribed capital and surplus.

Reserves. — Against all acceptances outstanding which mature in 30 days or less a reserve of at least 15 per cent shall be maintained, and against all acceptances outstanding which mature in more than 30 days a reserve of at least 3 per cent shall be maintained. Reserves against acceptances must be in liquid assets of any or all of the following kinds: (1) cash;

(2) balances with other banks; (3) bankers' acceptances; and (4) such securities as the Federal Reserve Board may from time to time permit.

XIV. DEPOSITS

In the United States. — No Corporation shall receive in the United States any deposits except such as are incidental to or for the purpose of carrying out transactions in foreign countries or dependencies of the United States where the Corporation has established agencies, branches, correspondents, or where it operates through the ownership or control of subsidiary corporations. Deposits of this character may be made by individuals, firms, banks, or other corporations, whether foreign or domestic, and may be time deposits or on demand. ⁴

Outside the United States. — Outside the United States a Corporation may receive deposits of any kind from individuals, firms, banks, or other corporations, provided, however, that if such corporation has any of its bonds, debentures, or other such obligations outstanding it may receive abroad only such deposits as are incidental to the conduct of its exchange, discount, or loan operations.

Reserves. — Against all deposits received in the United States a reserve of not less than 13 per cent must be maintained. This reserve may consist of cash in vault, a balance with the Federal Reserve Bank of the district in which the head office of the Corporation is located, or a balance with any member bank. Against all deposits received abroad the Corporation shall maintain such reserves as may be required by local laws and by the dictates of sound business judgment and banking principles.

XV. GENERAL LIMITATIONS AND RESTRICTIONS

Liabilities of one borrower. — The total liabilities to a Corporation of any person, company, firm, or corporation for money borrowed, including in the liabilities of a company or firm the

liabilities of the several members thereof, shall at no time exceed 10 per cent of the amount of its subscribed capital and surplus, except with the approval of the Federal Reserve Board: *Provided, however,* That the discount of bills of exchange drawn in good faith against actually existing values and the discount of commercial or business paper actually owned by the person negotiating the same shall not be considered as money borrowed within the meaning of this paragraph. The liability of a customer on account of an acceptance made by the Corporation for his account is not a liability for money borrowed within the meaning of this paragraph unless and until he fails to place the Corporation in funds to cover the payment of the acceptance at maturity or unless the Corporation itself holds the acceptance.

Aggregate liabilities of the Corporation. — The aggregate of the Corporation's liabilities outstanding on account of acceptances, average domestic and foreign deposits, debentures, bonds, notes, guaranties, indorsements, and other such obligations shall not exceed at any one time ten times the amount of the Corporation's subscribed capital and surplus except with the approval of the Federal Reserve Board. In determining the amount of the liabilities within the meaning of this paragraph, indorsements of bills of exchange having not more than six months to run, drawn and accepted by others than the Corporation, shall not be included.

Operations abroad. — Except as otherwise provided in the law and these regulations, a Corporation may exercise abroad not only the powers specifically set forth in the law but also such incidental powers as may be used in the determination of the Federal Reserve Board in connection with the transaction of the business of banking or other financial operations in the countries in which it shall transact business. In the exercise of any of these powers abroad a Corporation must be guided by the laws of the country in which it is operating and by sound business judgment and banking principles.

XVI. MANAGEMENT

The directors, officers, or employees of a Corporation shall exercise their rights and perform their duties as directors, officers, or employees, with due regard to both the letter and the spirit of the law and these regulations. For the purpose of these regulations the Corporation shall, of course, be responsible for all acts of omission or commission of any of its directors, officers, employees, or representatives in the conduct of their official duties. The character of the management of a Corporation and its general attitude toward the purpose and spirit of the law and these regulations will be considered by the Federal Reserve Board in acting upon any application made under the terms of these regulations.

XVII. REPORTS AND EXAMINATIONS

Reports. — Each Corporation shall make at least two reports annually to the Federal Reserve Board at such times and in such form as it may require.

Examinations. — Each Corporation shall be examined at least once a year by examiners appointed by the Federal Reserve Board. The cost of examinations shall be paid by the Corporation examined.

XVIII. AMENDMENTS TO REGULATIONS

These regulations are subject to amendment by the Federal Reserve Board from time to time, provided, however, that no such amendment shall prejudice obligations undertaken in good faith under regulations in effect at the time they were assumed.

APPENDIX NO. III

REGULATION OF THE FEDERAL RESERVE BOARD ON ACCEPTANCES

(Regulation C series of 1923)

ACCEPTANCE BY MEMBER BANKS OF DRAFTS AND BILLS OF EXCHANGE

ARTICLE A

Acceptance of drafts or bills of exchange drawn against domestic or foreign shipments of goods or secured by warehouse receipts covering readily marketable staples

SECTION I. STATUTORY PROVISIONS

Under the provisions of the sixth paragraph of section 13 of the Federal Reserve Act, as amended, any member bank may accept drafts or bills of exchange drawn upon it, having not more than six months' sight to run, exclusive of days of grace, which grow out of transactions involving the importation or exportation of goods; or which grow out of transactions involving the domestic shipment of goods, provided shipping documents conveying or securing title are attached at the time of acceptance; or which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples.¹ This paragraph limits

¹ A readily marketable staple within the meaning of these regulations may be defined as an article of commerce, agriculture, or industry of such uses as to make it the subject of constant dealings in ready markets with such frequent quotations of price as to make (a) the price easily and definitely ascertainable and (b) the staple itself easy to realize upon by sale at any time.

the amount which any bank shall accept for any one person, company, firm, or corporation, whether in a foreign or domestic transaction, to an amount not exceeding at any time, in the aggregate, more than 10 per cent of its paid-up and unimpaired capital stock and surplus. This limit, however, does not apply in any case where the accepting bank remains secured either by attached documents or by some other actual security growing out of the same transaction as the acceptance. A trust receipt which permits the customer to have access to or control over the goods will not be considered by Federal Reserve Banks to be "actual security" within the meaning of section 13. A bill of lading draft, however, is "actual security" even after the documents have been released, provided that the draft is accepted by the drawee upon or before the surrender of the documents. The law also provides that any bank may accept such bills up to an amount not exceeding at any time, in the aggregate, more than one-half of its paid-up and unimpaired capital stock and surplus; or, with the approval of the Federal Reserve Board, up to an amount not exceeding at any time, in the aggregate, more than 100 per cent of its paid-up and unimpaired capital stock and surplus. In no event, however, shall the aggregate amount of acceptances growing out of domestic transactions exceed 50 per cent of such capital stock and surplus.

SECTION II. REGULATIONS

1. Under the provisions of the law referred to above the Federal Reserve Board has determined that any member bank, having an unimpaired surplus equal to at least 20 per cent of its paid-up capital, which desires to accept drafts or bills of exchange drawn for the purposes described above, up to an amount not exceeding at any time, in the aggregate, 100 per cent of its paid-up and unimpaired capital stock and surplus, may file an application for that purpose with the Federal Reserve Board. Such application must be forwarded through the Federal Reserve Bank of the district in which the applying bank is located.

2. The Federal Reserve Bank shall report to the Federal Reserve Board upon the standing of the applying bank, stating whether the business and banking conditions prevailing in its district warrant the granting of such application.

3. The approval of any such application may be rescinded upon 90 days' notice to the bank affected.

ARTICLE B

Acceptance of drafts or bills of exchange drawn for the purpose of creating dollar exchange

SECTION III. STATUTORY PROVISIONS

Section 13 of the Federal Reserve Act also provides that any member bank may accept drafts or bills of exchange drawn upon it having not more than three months' sight to run, exclusive of days of grace, drawn, under regulations to be prescribed by the Federal Reserve Board, by banks or bankers in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange as required by the usages of trade in the respective countries, dependencies, or insular possessions.

No member bank shall accept such drafts or bills of exchange for any one bank to an amount exceeding in the aggregate 10 per cent of the paid-up and unimpaired capital and surplus of the accepting bank unless the draft or bill of exchange is accompanied by documents conveying or securing title or by some other adequate security. No member bank shall accept such drafts or bills in an amount exceeding at any time in the aggregate one-half of its paid-up and unimpaired capital and surplus. This 50 per cent limit is separate and distinct from and not included in the limits placed upon the acceptance of drafts and bills of exchange as described under Article A of this regulation.

SECTION IV. REGULATIONS

Any member bank desiring to accept drafts drawn by banks or bankers in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange shall first make an application to the Federal Reserve Board setting forth the usages of trade in the respective countries, dependencies, or insular possessions in which such banks or bankers are located.

If the Federal Reserve Board should determine that the usages of trade in such countries, dependencies, or possessions require the granting of the acceptance facilities applied for, it will notify the applying bank of its approval and will also publish in the Federal Reserve Bulletin the name or names of those countries, dependencies, or possessions in which banks or bankers are authorized to draw on member banks whose applications have been approved for the purpose of furnishing dollar exchange.

The Federal Reserve Board reserves the right to modify or on 90 days' notice to revoke its approval either as to any particular member bank or as to any foreign country or dependency or insular possession of the United States in which it has authorized banks or bankers to draw on member banks for the purpose of furnishing dollar exchange.

APPENDIX NO. IV

STATE BANKING LAWS RELATING TO ACCEPTANCES

Acceptance Bulletin, Feb., 1922, p. 19

STATE	MATURITY NOT MORE THAN	LIMIT TO ONE BORROWER	AGGREGATE OF OUTSTANDING ACCEPTANCES
Alabama.....	6 months	10 % Capital & Surplus (unless secured)	50 % Capital & Surplus. Members Federal Reserve System 100 % Capital & Surplus.
Arkansas.....	6 months	.....	100 % Capital & Surplus.
California.....	6 months	10 % Capital & Surplus	50 % Capital & Surplus. Supt. of Banks may authorize up to 100 %.
Connecticut	6 months	.....	50 % Capital & Surplus.
Georgia	6 months	10 % Capital & Surplus	50 % Capital & Surplus. Members Federal Reserve System 100 % Capital & Surplus when authorized by Reserve Board.
Indiana.....	12 months	.....	.....
Iowa.....	6 months	10 % Capital & Surplus	50 % Capital & Surplus. Supt. of Banks may authorize up to 100 % Capital & Surplus.
Louisiana.....	"on time"	.....	.....
Maine.....	.....	.....	50 % Capital & Surplus. Supt. of Banks may authorize up to 100 % Capital & Surplus.
Maryland.....	6 months	.....	.....
Massachusetts.....	6 months (import & export no limitations on domestic bills)	.....	50 % Capital & Surplus.

STATE BANKING LAWS RELATING TO ACCEPTANCES (*continued*)

STATE	MATURITY NOT MORE THAN	LIMIT TO ONE BORROWER	AGGREGATE OF OUTSTANDING ACCEPTANCES
Michigan.....	6 months	.....	50 % Capital & Surplus.
Mississippi.....	6 months	10 % Capital & Surplus (unless secured)	50 % Capital & Surplus.
Missouri.....	12 months	.....	100 % Capital & Surplus (except with approval of Bank Commission).
Montana.....	12 months	20 % Capital & Surplus	.....
New Jersey.....	12 months	10 % Capital & Surplus	.....
New York.....	12 months	10 % Capital & Surplus (with exceptions)	Banks joining Federal Reserve System are limited to 100 % Capital & Surplus.
North Carolina....	6 months	25 % Capital & Surplus (unless secured)	100 % Capital & Surplus.
Ohio.....	6 months	20 % Capital & Surplus (unless secured)	100 % Capital & Surplus.
Oregon.....	(not more than) 6 months	20 % Capital & Surplus (unless secured, aggre- gate when secured 100 %)	.....
Pennsylvania.....	12 months	.....	.....
Rhode Island.....	12 months	20 % Capital & Surplus	.....
Tennessee.....	12 months	.....	100 % Capital & Surplus (except with consent of Bank Supt.).
Texas.....	6 months (importation and exportation of goods)	.....	50 % Capital & Surplus.
Virginia.....	12 months	10 % Capital & Surplus	.....
West Virginia.....	12 months	.....	.....

APPENDIX NO. V

STATISTICS ON THE AMERICAN ACCEPTANCE MARKET (in dollars, 000 omitted)

1. ACCEPTANCE LIABILITIES OF MEMBER BANKS AS COMPARED WITH MEMBER BANK ACCEPTANCES HELD BY FEDERAL RESERVE BANKS.

1919		Percentage of total Member Bank Accept- ances Out- standing
Acceptance Liabilities	Member Bank Acceptances	
Mar. 4, 451,265	Feb. 28, 219,323	48.6
June 30, 466,586	June 30, 233,519	50.0
Nov. 17, 565,677	Nov. 30, 347,852	61.5
Dec. 31, 641,018	Dec. 31, 405,339	63.2

1920		Percentage of total Member Bank Accept- ances Out- standing
Acceptance Liabilities	Member Bank Acceptances	
May 4, 673,852	End Apr. 270,808	40.2
June 30, 673,567	End June 255,564	37.9
Nov. 15, 647,801	End Nov. 153,302	23.7
Dec. 29, 593,708	End Dec. 169,387	28.5

1921		Percentage of total Member Bank Accept- ances Out- standing
Acceptance Liabilities	Member Bank Acceptances	
Apr. 28, 504,169	End Apr. 62,327	13.4
June 30, 431,887	June 30, 26,787	6.2
Dec. 31, 368,800	End Dec. 110,264	30.0

1922		Percentage of total Member Bank Accept- ances Out- standing
Acceptance Liabilities	Member Bank Acceptances	
Mar. 10, 316,755	End Feb. 69,915	22.1
June 30, 320,770	End June 127,051	39.6
Dec. 29, 400,191	End Dec. 189,176	47.3

1923		Percentage of total Member Bank Accept- ances Out- standing
Acceptance Liabilities	Member Bank Acceptances	
Apr. 3, 421,371	March 31, 183,366	43.5
June 30, 365,200	June 30, 140,958	38.6
Dec. 31, 426,397	Dec. 31, 239,361	56.1

2. TOTAL BANKERS' ACCEPTANCES OUTSTANDING AS COMPARED
WITH HOLDINGS OF FEDERAL RESERVE BANKS.

Date	Total Accept- ances Out- standing	Date	Holdings of Acceptances Bought in Open Market	Per- cent- age
		(Average daily holding)		
April 1, 1920	799,001	1920	388,746	48.6
April 1, 1921	664,092	1921	91,817	13.8
April 1, 1922	416,422	1922	159,207	38.2
April 1, 1923	523,707	1923	226,548	36.7

3. AVERAGE FEDERAL RESERVE BANK HOLDINGS OF BANKERS' ACCEPTANCES AT THE END OF EACH MONTH CLASSIFIED AS TO ACCEPTORS.

Year	Member Banks	Per cent of total	Non-Member Banks	Per cent of total	Branches and Agencies of Foreign Banks	Per cent of total
1920	249,017	67.7	91,593	24.9	27,078	7.4
1921	57,344	63.9	23,303	26.0	9,106	10.1
1922	123,393	74.4	33,027	19.9	9,330	5.6
1923	157,942	68.4	58,890	25.5	14,200	6.1

4. FEDERAL RESERVE BANK'S HOLDINGS OF ACCEPTANCES ARISING OUT OF THE FOREIGN TRADE ON THE LAST DAY OF EACH MONTH.

		Total	
		Imports	Exports
1921	January.....	58,296	61,674
	February.....	67,526	57,022
	March.....	48,285 ¹	36,688
	April.....	42,768	33,922
	May.....	30,105	19,856
	June.....	14,993	13,478
	July.....	5,294	6,746
	August.....	14,127	11,965
	September.....	14,206	13,940
	October.....	25,848 ²	26,464
	November.....	26,338	22,595
	December.....	49,995 ³	45,220
	Average.....	33,148	29,131

¹ Total holdings of Dallas, \$20,904, not classified and not included.

² Total holdings of Atlanta and New Orleans, \$3,680,989, not classified and not included.

³ Total holdings of Cleveland, \$4,352,842, not classified and not included.

		Total	
		Imports	Exports
1922	January	22,922	26,457
	February	39,659	25,752
	March	49,276	27,738
	April	42,576	24,775
	May	48,003	39,719
	June	65,469	57,979
	July	65,303	49,104
	August	78,625	65,337
	September	88,637	64,162
	October	98,572 ¹	74,079
	November	92,215	85,095
	December	106,803	85,022
	Average	66,422	52,077
1923	January	85,351	58,171
	February	91,301	55,134
	March	135,880	68,274
	April	151,579	61,392
	May	143,621	55,340
	June	114,441	46,211
	July	105,014	35,207
	August	100,566	31,748
	September	85,467	43,087
	October	81,773	63,608
	November	111,954	98,530
	December	123,309	119,911

¹ Total holdings of Cleveland, \$31,491,553, not classified and not included.

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